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MAJOR TAX REFORM OPTIONS

HEARINGS

BEFORE THE

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UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

AUGUST 7 AND 9, SEPTEMBER 11 AND 20, 1984

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MAJOR TAX REFORM OPTIONS

TUESDAY, AUGUST 7, 1984

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 10:04 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Robert J. Dole (chairman) presiding.

Present: Senators Dole, Packwood, Roth, Danforth, Chafee, Heinz, Durenberger, Symms, Grassley, Long, Baucus, and Bradley.

Also present: Messrs. DeArment and Stern.

[The press release announcing the hearing, an analysis of the Senate proposals relating to comprehensive tax reform by the Joint Committee on Taxation, and Senators Dole, Grassley, and Baucus, statements follow:]

[Press Release No. 84-156]

U.S. SENATE,
COMMITTEE ON FINANCE,
SD-219 Dirksen Senate Office Building.

For immediate release, July 16, 1984.

FINANCE COMMITTEE SETS HEARINGS ON MAJOR TAX REFORM OPTIONS

Senator Robert J. Dole (R., Kansas), Chairman of the Senate Finance Committee, announced today that the Committee would hold hearings on options for a major revision of the tax system on Tuesday, August 7 and Thursday, August 9, 1984. The hearings will focus on proposals that have been set forth for a flat-rate income tax, or for a simplified income tax with lower rates and fewer exceptions from the tax base, and on alternative suggestions such as a value added tax; a national sales tax, a tax based on consumption rather than income, or a gross income tax.

The hearing will begin each day at 10:00 a.m. in Room SD-215 of the Dirksen Senate Office Building.

"In September of 1982 the Finance Committee began an examination of flat-rate and other major tax reform proposals. This is an issue that has attracted considerable attention since our action in 1981 to reduce tax rates across the board, and the measures to broaden the tax base that have been undertaken since then. There seems to be a growing consensus that lower tax rates coupled with a broader tax base, or a tax based on consumption in some form, could be fairer to the taxpayer as well as better for the economy," Dole said.

Senator Dole indicated that the Finance Committee would examine the details of substantive proposals that have been made, and would be interested in receiving testimony on alternative tax proposals to achieve the goals of greater equity, simplicity, balance, and economic efficiency in the tax system.

"These hearings should serve to open a highly significant debate over the direction of tax policy next year and in the years ahead, and there are many difficult questions that need to be answered," Senator Dole stated. "We may agree on general goals for tax policy, but how you proceed makes a great deal of difference to the taxpayer and the economy. If we are serious about developing a truly equitable tax system, we must be prepared to address these issues openly and honestly."

Among the major issues cited by Senator Dole that would be of concern to the Committee were the distributional impact of lowering tax rates while eliminating most tax preferences; the degree of progressivity desired in the system; the difficulty of making the transition to a new system when many taxpayers have made long-term economic decisions in reliance on the tax preferences and rate structure that now exist; and how to simplify taxation for both individuals and corporations, including the question of whether income should be taxed without regard to the form of business organization.

"If we are interested in undertaking a major overhaul of our tax system, we have to be attentive to the concerns of individuals and businesses who have planned their activities based on the present system. In particular, we cannot just address the way we tax individuals and ignore the effect that might have on those who have to decide whether to incorporate or operate as a proprietorship. The corporate side also must be addressed," Senator Dole stated. "Our interest as a Committee is in building a tax system that will be supported by a broad consensus so that the goals of equity and efficient revenue-raising will not be undermined in the years ahead. We hope that our hearings will lay the groundwork for that effort."

ANALYSIS OF SENATE PROPOSALS RELATING TO COMPREHENSIVE TAX REFORM

SCHEDULED FOR HEARINGS

BEFORE THE

COMMITTEE ON FINANCE

ON AUGUST 7 AND 9, 1984

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

This pamphlet has been prepared by the staff of the Joint Committee on Taxation in connection with the hearings scheduled by the Senate Finance Committee for August 7 and 9, 1984. The hearings concern major tax reform options. Part I of the pamphlet discusses the general objectives of comprehensive tax reform. Part II describes the basic characteristics of base broadening and rate reduction proposals. Part III analyzes some important issues in considering major modifications to the income tax. Part IV deals with problems of making a transition from the present system to a new system. The appendix summarizes Senate bills and proposals during the 98th Congress which provide for comprehensive tax reform.

I. OBJECTIVES OF COMPREHENSIVE TAX REFORM PROPOSALS

Several criteria are commonly used when evaluating tax proposals, including equity, efficiency, and simplicity. Individuals often agree that the revenue which is raised by the tax system should be collected in a manner which is as fair as possible, which produces as little unintended distortion in the economy as possible, and which is as simple to administer and understand as possible. In addition, certain provisions of the tax system have been enacted to encourage specific activities which Congress has felt should be promoted. The questions of equity, efficiency, simplicity, and the encouragement of specific activities are central to the discussion of whether the present tax system should be changed by enacting one of the comprehensive tax proposals currently being discussed.

A. Equity

Horizontal equity and ability to pay taxes

A common assertion is that taxes, other than user fees collected from beneficiaries of specific programs, should be collected in accordance with a taxpayer's ability to pay taxes. Thus, taxpayers with equal ability to pay taxes should pay equal amounts of tax and, correspondingly, any taxpayer with a greater ability to pay should pay more tax. This concept is sometimes called horizontal equity. An additional dimension of equity, sometimes known as vertical equity, is the actual amount by which the tax liability of the taxpayer with the higher ability to pay exceeds that of the other taxpayer.

Income as a measure of ability-to-pay

To apply concepts of equity to the design of a tax system, it is necessary to measure each taxpayer's ability to pay taxes. In the United States, there is a tradition that a taxpayer's income is a valid measure of his or her ability to pay taxes. In this context, income is defined as the ability to provide oneself with goods and services, other than those goods and services which are necessary to earn the income. Thus, for this purpose, income is generally measured by subtracting from the sum of the gross receipts and appreciation in asset value of a taxpayer the amounts spent on goods or services which are costs of generating those gross receipts and that appreciation.

Although there are many problems obtaining all the information necessary to produce an accurate measure of income (some of the most important problems are discussed in the third part of this pamphlet), income is a commonly accepted measure of ability to pay taxes. It is often asserted that individuals with a relatively high ability to purchase goods and services which satisfy needs for private consumption also have a relatively high ability to purchase those goods and services which provide for public consumption needs, i.e., goods and services provided by the government. If it is then agreed that those with a relatively high ability to purchase these goods and services should also be required to make a relatively high contribution toward defraying their cost, then it follows that the revenues necessary to pay for government spending should be raised by an income tax.

On the other hand, several arguments may be put forth as to why income should not be relied on as the basic index of ability to pay taxes. First, some assert that actual consumption of goods and services, not potential consumption (i.e., income), is a fairer basis for taxation. This is consistent with the belief that taxation should be based on the actual satisfaction derived from goods and services, rather than the ability to purchase them, and actual satisfaction may be more closely related to expenditures for goods and services than to income.

Second, it can be argued that income may be misleading as a single index of ability to pay taxes because no account is taken of the time and effort expended on earning that income. Some would argue, for example, that someone who works 20 hours per week to earn a given amount of income should pay more tax than someone who works 40 hours per week to earn the same amount. This is because the former taxpayer has greater leisure time to enjoy the available goods and services and because one's leisure is itself valuable. Similarly, it may be argued that someone who works at a less pleasant job should pay less than someone with the same income who works in a more pleasant environment. Yet, under a tax system in which tax liability is based solely on income, no account is taken of these differences, and it would be extremely difficult to design a tax system that took these and similar problems into account.

A third problem is disagreement over what expenses should be subtracted from gross receipts as a cost of earning income. For example, questions have arisen about the extent to which business meals and entertainment should be deductible. Also, it can be argued that medical expenses should be deducted from the amount subject to tax because these expenses are the cost of maintaining health, which is necessary to earn income.

Vertical equity

In spite of these problems, in the U.S. income has been commonly accepted as a basis for taxation. Thus, the horizontal equity concept requires that taxpayers with equal incomes should have equal tax liabilities. Vertical equity is much more subjective since it involves the comparison of ability to pay for taxpayers with different amounts of resources. Since there is no widely accepted yardstick for making these comparisons, the degree to which tax liability should vary with income is a value judgment.

The concept of progressivity is often discussed in this context. A progressive tax is one for which the ratio of tax liability to the tax base (e.g., income) rises as the tax base rises. Many argue that this is appropriate. On the other hand, others contend that the ratio of taxes to income should be constant (a proportional tax system).

Still others believe that the ratio of taxes to income should decline as income rises (a regressive system).

One argument for progressivity is that, if people examined the vertical equity question from the point of view of the very beginning of their lives, when they did not know exactly where they would end up in the income distribution, they would be willing to agree to laws under which government would mitigate, to some extent, whatever inequalities emerged from a market economy. Progressivity is criticized, however, by those who view a taxpayer's income as essentially the fruit of his or her own labor and resources. Under this view, the government should have very little role in equalizing the amounts with which individuals are left after taxes, since individuals are entitled to whatever income arises from their own labor or property. This view is, in turn, contested by those who contend that labor and property have value only because society establishes laws and regulations which allow each individual to engage in economic activity with relatively little interference from others. To be sustained, these laws and regulations must be accepted even by those who are relatively unsuccessful. Thus, because society establishes the framework which allows labor and property to be valuable resources, it can also establish a progressive tax system and other mechanisms to achieve an equitable distribution of income.

In sum, although equity is an integral part of tax policy, it involves subjective judgments over which there is likely to be considerable disagreement.

B. Efficiency

Another widely accepted goal of tax policy is that taxes should interfere as little as possible with the incentives to engage in specific types of economic activity, except to the extent that Congress intends such effects. This goal is known as economic efficiency.

Virtually any tax which meets accepted equity criteria creates some interference with economic incentives. In order to have no such effect, a tax would have to be determined on the basis of some characteristic over which an individual has no control. For example, a head tax equal to a specified, constant amount per person would have no incentive effects, since it could not be avoided, but it also would be regarded by many as extremely unfair. On the other hand, a tax which varies with income creates a disincentive for earning income. Even taxes on consumption create disincentives for earning income since they reduce the potential amount of goods and services which may be purchased with the income earned from a given amount of property or work effort.

Similar trade-offs may exist with respect to vertical equity and efficiency. For example, it has been argued that a progressive tax system creates considerable inefficiency by encumbering additional income with the imposition of a still higher tax rate. In the extreme case, a 100-percent tax on additional income would eliminate any incentive to earn that income. Yet, from the point of view of equity, many argue that progressive tax rates are essential to establish a proper relationship between tax burdens and ability to pay. Therefore, given the notions of horizontal and vertical equity that are commonly accepted, there is frequently a conflict between the efficiency and equity goals of tax policy. Balancing these competing considerations is one of the most difficult aspects of formulating a tax system.

The concept of economic efficiency uses as a benchmark the production of goods and services which would occur in a market economy in the absence of taxes. Economists generally regard this allocation of resources as a useful reference point because, under certain conditions, it insures that available economic resources are arrayed in such a way as to produce the highest possible amount of consumer satisfaction. Relative to this benchmark, taxes change the incentives to engage in various types of economic activity (e.g., work, investment, consumption of specific goods and services), which reduces the ability of the economy to satisfy consumer demands.

Thus, some inefficiency is inherent in virtually all taxes which are acceptable from the equity standpoint. However, a major goal of tax policy is to reduce this inefficiency to as low a level as possible.

C. Simplicity

A third goal of tax policy is simplicity. This is a serious concern for at least two basic reasons—compliance costs and the perception of equity.

First, a complicated tax system requires a large amount of resources to administer and understand. When the system has a large number of discrete provisions and mandates that many fine distinctions are to be made among types of income or expenses, a long series of complicated rules is necessary. The agency administering the system must have a large staff to formulate the rules and to insure that taxpayers calculate tax liability correctly. Taxpayers themselves must invest large amounts of time in understanding the rules so as to avoid overpaying their taxes, or alternatively, find that they are better off by paying for professional tax advice and preparation. This time and effort diverted from other activities is a source of inefficiency generated by the tax system in addition to the disincentive effects described in the previous section.

A second reason for a general preference for a simple tax system is that under a complicated system, similarly situated taxpayers may have different tax liabilities because they are not equal in their ability to understand the rules or pay for professional tax advice. This situation may undermine the perception that the tax system is horizontally equitable. Taxpayers may suspect that others are paying less tax not because they have lower ability to pay, but rather because they have better access to knowledge about the details of the system. If these feelings are widespread they may contribute to a feeling that the system is not fair.

A very simple tax system, however, may rank low from the equity and efficiency viewpoints. For example, a complete measure of income includes all fringe benefits. The failure to tax all fringes may lower the equity of the system by not imposing equal taxes on individuals with equal income; the efficiency of the system would be lowered because artificial incentives would be created for greater consumption of these benefits. However, it may be quite complex to define the rules necessary to tax certain forms of fringe benefits. Thus, as with other elements of tax policy, a balance must be struck among competing objectives.

D. Stimulating Other Activities

Some provisions of the tax law have been enacted to encourage particular activities by individuals and businesses, rather than to promote the goals discussed above. For example, when Congress enacted tax credits for energy conservation expenditures, it did so not to increase the equity, efficiency, or simplicity of the tax system, but rather to increase spending on goods which reduce energy consumption. This subsidy could have been provided through a spending program, but, instead, the tax system was chosen as the means by which the subsidy was administered.

In certain cases, there are advantages to providing subsidies through the tax system, since it provides an administrative mechanism, already in place, reaching a large majority of the American public.

At the same time, providing the subsidy through the tax system rather than some other mechanism may tend to interfere with the equity of the tax system. These subsidies result in a system in which tax liability is not made equal for taxpayers with equal ability to pay, and they change the relationship of tax liabilities for taxpayers with different levels of ability to pay. Further, such subsidies make the system more complicated, and may raise questions of efficiency. Although the provision of these subsidies through another administrative mechanism also would involve similar issues of equity, efficiency, and simplicity, taxpayers' perceptions of the workings of the entire tax system may be affected when they are administered through a tax mechanism.

II. CHARACTERISTICS OF COMPREHENSIVE TAX PROPOSALS

The Appendix of this pamphlet provides a description of the comprehensive tax proposals which have been introduced in the Senate during the 98th Congress. While the details of these bills vary substantially, it is useful to categorize into five groups the changes these bills would make in the present tax system:

(1) The bills generally would expand the tax base by repealing a variety of deductions, exclusions and credits in the present system.

(2) Marginal tax rates applied to the base would be lowered substantially.

(3) The degree of steepness in rate schedule, the rate at which marginal tax rates increased with income, would be reduced.

(4) The aggregate distribution of tax burdens by income class would be altered by some of the proposals.

(5) The total amount of revenue raised by the corporate and individual income taxes would be changed by some of the proposals. This part of the pamphlet considers some of the features of the present income tax which are relevant to these issues and contains a general discussion of them.

A. Changes in the Tax Base

All of the proposals under discussion would make substantial changes in the tax base. In all cases, significant items not now subject to tax would be included in the base.

Many of the proposals adopt a relatively comprehensive definition of income as the primary basis for taxation. The designers of most of the proposals appear to have made the judgment that income is the best measure of taxpaying capacity and that taxpayers with equal income should have equal tax liability. In addition, it appears that they believe that many of the exclusions, deductions, and credits in the present system are inequitable, inefficient, or complex, or at least have decided that the benefits that these provisions may have are outweighed by the advantages of the other changes made by the bills, such as reductions in marginal tax rates.

Important background for analyzing these base-broadening proposals is provided by comparison of the amount of income actually subject to tax under the present individual income tax and the income recorded in the national income and product amounts. Table 1 presents the relationship between gross national product and taxable income in the United States in 1982.

Gross national product was more than double the estimated individual income tax base—$3.1 trillion versus $1.2 trillion. The $1.9 trillion difference is composed of two parts. First, about $0.2 trillion of income items are included in the tax base but not gross national product. These include certain government subsidies and transfer payments, certain interest income, and a portion of capital gains. Although not included in GNP, many would argue that these are properly includible in an income tax base. In fact, substantial additional portions of transfer payments and capital gains would be subject to tax under various proposals.

Table 1.—Reconciliation of GNP and Taxable Income, 1982

[In billions of dollars]

Item	Amount
Gross National Product (GNP)	3,073.0
−Depreciation	−359.2
−Indirect business taxes	−258.3
−Statistical discrepancy	−.5
+Government subsidies	+9.5
−Corporate retained earnings and corporate income tax	−98.4
−Employer social insurance contributions	−141.0
+Net interest paid by government and consumers	+105.1
+Taxable government transfers	+35.7
−Fringe benefits excluded from AGI	−154.5
−Imputed income in GNP	−72.0
−Investment income of insurance companies and pension funds	−64.0
−Investment income of nonprofit organizations and fiduciaries	−25.4
−Differences in accounting treatment between GNP and AGI	−25.8
−Income of nonfilers and unreported income	−171.5
−Other discrepancies between GNP and AGI	−42.9
−IRA deductions	−27.8
−Second-earner deduction	−8.9
+Capital gains in AGI	+32.5
+Taxable private pensions	+42.0
+Subchapter S corporation income	+.2
Adjusted gross income (AGI)	1,847.8
−AGI on nontaxable returns	−51.5
−Medical deduction	−17.2
−Tax deduction	−85.4
−Interest deduction	−111.9
−Charitable deductions	−32.1
−Other deductions	−18.0
+Floor under itemized deductions (zero bracket amount on itemizing returns)	+100.0
−Personal exemptions	−190.7
Taxable income on taxable returns (net of deficits)	1,441.0
−Deduction equivalent of tax credits (estimated)	−21.2
−Zero bracket amount (estimated)	−220.0
Tax base (estimated)	1,199.8
Income tax after credits	276.9

Sources: *Survey of Current Business*, April 1984; *Statistics of Income: SOI Bulletin, Winter 1983-84* and *Spring 1984*, Internal Revenue Service; and staff estimates.

The second component of the difference between GNP and taxable income is approximately $2.1 trillion of income and deduction items which are included in GNP but not in the tax base. Much of this difference, however, would not be available for net base broadening under a revised income tax. First, approximately $0.6 trillion consists of economic depreciation and indirect business taxes, which may be considered as costs of earning income. Second, $0.1 to $0.2 trillion of income is not reported; subjecting this amount to tax would depend on compliance measures rather than changes in the statutory tax base. Third, corporate retained earnings were approximately $0.1 trillion. This amount already is subject to tax at the corporate level, and thus a substantial portion of this may not be available for broadening the combined base of the corporate and individual taxes. Fourth, the approximately $0.5 trillion accounted for by the zero bracket amount, personal exemptions, adjusted gross income on nontaxable returns, and income of nonfilers whose income is below the filing requirement is most usefully thought of as part of the rate structure. (Equity considerations lead the designers of all these proposals to exempt some amount of income from tax, using either a zero bracket amount, personal exemptions, tax credits or a combination of these approaches). The total of these four amounts generally not available for base broadening is approximately $1.3 trillion. Thus, of the $2.1 trillion of items not included in the tax base under the present system, about $0.8 trillion could realistically be included in the base of a comprehensive tax on net income. This consists of about $0.6 trillion of fringe benefits, investment income of pension plans and nonprofit organizations, and other items not included in adjusted gross income, and about $0.2 trillion of itemized deductions (in excess of the zero bracket amount) and tax credits. If these items had been included in taxable income in 1982, the tax base would have been approximately 60 percent larger.

The proposals summarized in the Appendix broaden the tax base considerably by increasing the amounts of capital gains, transfer payments, fringe benefits, investment income and other income items included in the tax base and by reducing allowable deductions and credits. At this time, however, a quantitative analysis of the extent of this base broadening for each proposal is not available.

B. Lowering Marginal Tax Rates

In all of the proposals, marginal tax rates are substantially reduced. This reduction appears to be motivated by efficiency and equity considerations.

Efficiency

Many economists would agree that high marginal taxes can cause considerable economic inefficiency, both by interfering with the incentives for work and saving, and by magnifying the effects caused by differences between the tax base which may be chosen purely for efficiency reasons and the base which actually is implemented in the law.

An individual's marginal tax rate is the rate applicable to the last or to the next dollar of income received. If an individual is subject to a 25-percent marginal rate, then the return to additional work effort and saving is reduced by 25 percent. For example, if this individual is considering working on an overtime assignment which pays $40, then the after-tax reward to this work effort is $30. A higher marginal tax rate would reduce the return to this work effort even further, affecting the incentive to undertake the assignment. A similar point may be made with respect to investment decisions. If the individual with a 25-percent marginal rate invests in a security with a 10-percent return, the after-tax return would be 7.5 percent. Thus, the marginal tax rate affects the incentive to save rather than use the same resources for current consumption. The same reasoning may be used to show that marginal tax rates also influence the incentives to engage in activities which are heavily taxed versus those which are lightly taxed. With high marginal rates, for example, there is more incentive to invest in lightly taxed investments or to take jobs in which a high proportion of compensation is in the form of non-taxable fringe benefits than would be the case with low marginal rates.

Effect on labor supply

The effect of changes in marginal tax rates in distorting incentives is sometimes referred to as the "substitution effect." Most of the studies which have been performed on the effect of after-tax wage rates on work effort have found that the substitution effect of after-tax wage changes in hours worked is quite small for husbands but rather large for wives, especially wives with children. Since the substitution effect is measured by holding after-tax income constant, this is the proper measure of the incentive effect of a marginal rate reduction, as opposed to the "income" effect which would occur because of the income increase attributable to any tax reduction. This empirical finding is confirmed in one of the more recent and sophisticated studies,[1] except that a significant substitution effect is found for husbands, as well as wives. Thus, these studies indicate that if marginal tax rates were lowered, holding other factors (including after-tax income) constant, some individuals would be willing to work a larger number of hours. This could be manifested as greater willingness to work full-time instead of part-time, greater acceptance of overtime assignments, less absenteeism, and a larger number of individuals in the labor force.[2]

It should also be noted that there are several other possible impacts of marginal tax rates on work-related activities. First, it has been argued that reduction in marginal tax rates could improve compliance with the income tax, although there is little evidence which bears directly on this question. Second, it has been argued that high marginal tax rates have induced employees to demand a larger portion of their compensation in the form of tax-free fringe benefits, such as health insurance, than would be the case with lower marginal rates, and this substitution of fringe benefits for cash may reduce the efficiency with which the economy satisfies employees' needs. To the extent that such effects exist, they would be lessened if marginal tax rates were lowered.

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[1] Jerry A. Hausman, "Labor Supply," in Henry J. Aaron and Joseph A. Pechman, eds., *How Taxes Affect Economic Behavior*, Brookings Institute, 1981.

[2] It should be noted that a tax proposal which raised after-tax income could have offsetting "income" effects because some individuals would respond to their additional income by taking more leisure time. Thus, the evidence of a significant substitution effect does not mean that a tax cut would necessarily increase labor supply, only that a cut in marginal tax rates offset by other changes in after-tax income would do so.

Effect of marginal tax rates on saving

If an individual saves a dollar rather than spending it on current consumption, he or she generally will be able to have in excess of one dollar available for consumption in a future period. The amount of this excess depends on the return available for funds saved and on the marginal tax rate applicable to this return. The quantity of consumer goods which can be purchased in the future with a given amount of money will depend on the rate of inflation. Thus, the after-tax return (adjusted for inflation) determines the extra future consumption that a person can have by saving and thus sacrificing one dollar of current consumption. The lower the after-tax return, the more attractive is the option to consume now rather than save. As an important determinant of the after-tax return, the marginal tax rate is likely to affect this choice.

As in the above analysis of work effort, it is important to distinguish between the income and substitution effects of marginal tax rate changes on the choice between current and future consumption. Any tax reduction, including a reduction in marginal rates, will increase after-tax income and thus generally will lead to an increase in both current and future consumption. However, as discussed above, marginal tax rate reductions also would have incentive, or substitution effects, because they change the rate at which the taxpayer can trade off between current and future consumption. This discussion emphasizes the substitution effects, which are unique to marginal tax rate reductions and which measure the economic inefficiency created by taxes.

Three distinct sources of concern with high marginal tax rates have been cited by economists who have analyzed the effects of the income tax on current and future consumption. The first concern is the effect of the marginal tax rates on individuals' incentives to consume in current rather than future periods; the second is the effect of marginal tax rates on aggregate saving, investment, and productivity; and the third involves the effect of the tax system on the composition of saving as a result of its effect on incentives to invest in lightly taxed versus heavily taxed activities and its incentive to borrow—the deduction for nonbusiness interest.

The fact that the marginal tax rates implicit in the current income tax discourage future consumption creates a distortion (relative to a tax system with a marginal rate of zero, such as a per capita head tax). The importance of this distortion depends on the responsiveness of future consumption to a change in the after-tax rate of return on saving, holding income constant. Empirical studies of this sensitivity are much less numerous than those of labor supply response. The methodological difficulties of studying the responsiveness of consumption to the rate of return are greater because the expected real return (net of expected inflation) must be measured and because the statistical analysis must be performed using time series of observations on total U.S. income and consumption. This methodology requires the assumption that the quantitative relationships among the variables have been unchanged for a long period of time. In spite of these methodological problems, empirical studies do indicate that individuals' plans for future consumption are sensitive to the after-tax rate of return. The marginal tax rate on capital income also may affect the choice between labor and leisure, as well as the choice between present and future consumption. For example, a greater after-tax rate of return may make it more attractive for individuals to work for the purpose of increasing their consumption in retirement years. However, this sort of effect has not been firmly substantiated in empirical research.

The second major concern which has been raised concerning the effect of marginal tax rates on capital income has been their effect on aggregate savings and, thus, investment and productivity. For a variety of reasons, however, the link between aggregate investment and the marginal tax rates in the individual income tax is very uncertain. First, investment may be affected much more directly by other factors, such as the tax treatment of depreciation allowances. Second, the effect of income tax changes on private saving could be offset to the extent that there is a revenue loss, which leads to less government saving. Finally, even though it is likely that a higher after-tax return may increase future consumption, it is not clear as a theoretical matter that personal savings would increase simultaneously. This is the case because a higher return on savings actually lowers the amount which an individual needs to save in the current period in order to achieve any future consumption goal. Personal saving would increase in response to an increase in the after-tax rate of return only if desired future consumption increases sufficiently to offset this effect. Whether this is, in fact, the case can be determined only by empirical studies. Although these studies are extremely difficult to perform for the reasons discussed above, there is some indication that future consumption may be stimulated sufficiently by increasing the after-tax return that total personal saving may increase modestly in response to such a change.

The income tax also influences decisions about the particular forms in which taxpayers do their saving, which affects the allocation of capital in the economy. The first concern is that the income tax imposes heavier tax rates on some activities than others (e.g., tax shelters, owner-occupied housing, and precious metals). This provides an incentive to shift from the heavily taxed activities, which may be more productive, to lightly taxed activities. The size of this incentive depends on the marginal tax rate. Thus, it is argued, reducing the marginal tax rate may encourage individuals to shift from less productive to more productive forms of saving. The second concern relates to the present law deduction for nonbusiness interest. Since this provision is, in effect, an encouragement for borrowing, i.e., dissaving, it is argued that reducing marginal tax rates could encourage saving by reducing the incentive to borrow. Finally, it is argued that because the income from assets subject to capital gains treatment is taxed only when the assets are sold, high marginal tax rates discourage sales and prevent these assets from being employed in their most efficient uses. Thus, lower marginal income tax rates could increase efficiency by reducing this "lock-in" effect.

The bills discussed here tend to take several approaches to improving saving incentives. All of the bills attempt to achieve greater uniformity in the tax treatment of saving and income from capital by reducing or eliminating preferential treatment for certain types of saving relative to others. Also, the bills reduce marginal tax rates, which reduces the adverse impact of whatever distortions remain. Some of the bills, however, go farther than this and attempt to structure a system in which the effective tax rate on saving is zero.

Equity

From an equity perspective, reducing marginal tax rates also may be viewed as desirable. Many argue that it is unfair for a high portion of each additional dollar of income earned by an individual to be absorbed as increased tax liability. In passing the Economic Recovery Tax Act of 1981, Congress lowered the highest marginal rate in the tax schedules from 70 percent to 50 percent. Much of the discussion of this change involved the belief that a marginal tax rate as high as 70 percent caused undue interference with the incentives for efficient economic performance. However, another important source of support for this reduction was the feeling that it was unfair for the tax system to claim more than half of each additional dollar earned by taxpayers. Presumably, this indicates that one accepted equity objective of tax policy is to keep marginal tax rates below some threshold level.

C. Reducing the Progressivity of the Rate Schedules

The authors of the proposals appear to believe that it is desirable to reduce significantly the number of tax brackets in the rate schedules and to reduce the difference between the bottom and top rates of the income tax. Some of the proposals have one flat tax rate that applies to all income not exempt from taxation.

It is important to emphasize that the issue of the degree of progressivity in the rate schedules is to some extent independent of the broad vertical equity issue of the relative distribution of tax burdens by income class. That is, the distribution of tax burdens is affected not only by the degree of progressivity in the rate schedules, but by other structural elements of the income tax as well. For example, during 1981 the Ways and Means Committee considered a proposal to reduce the number of brackets in the rate schedule, to widen the first bracket so that a majority of taxpayers were subject to the same tax rate, and to increase the personal exemption and zero bracket amount to offset the rate increases imposed on the lowest income taxpayers. These revised rate schedules produced approximately the same amount of progressivity as under prior law. Thus, some flattening of the rate schedule is possible even without large changes in the distribution of the tax burden.

There are several advantages to a flat or flattened rate schedule. For example, if taxpayers are more likely to be in the same tax bracket over a period of years, tax considerations would be less likely to influence the timing of transactions. This would reduce one of the sources of inefficiency of a progressive rate schedule. If most taxpayers faced the same tax rate, there would be less incentive to shift income to low bracket family members, which may improve the perception of equity in the system. The difference in tax treatment between married couples and single individuals would be reduced, since, in a system in which married couples may pool their income and file a joint return, this difference arises from the fact that the amount of income taxed at each rate depends on marital status. Finally, a flatter tax rate would allow a closer correspondence between amounts withheld and tax liability. In a system in which the tax rate did not depend on taxpayer's income, as is the case under the present social security payroll tax, withholding could be closer to tax liability in the vast majority of cases.[3] It should be emphasized that although some flattening is compatible with a progressive distribution of tax burdens, that is, a system in which tax liability as a percentage of income increases as income rises, adopting a rate schedule with just one rate would impose strict limits on the degree of progressivity which could be obtained. Some progressivity could be attained by exempting some fixed amount of income from taxation for all individuals, but the pattern of progressivity in the present system (discussed below) probably could not be duplicated.

D. Changing the Distribution of Tax Burdens by Income Class

One of the central issues in analyzing an alternative proposal is the relationship of the tax burdens of taxpayers with different levels of income. Table 2 presents the average tax rate projected under present law for 1985. In preparing this table, taxpayers were put into categories according to their expanded income, a concept somewhat broader than the present definition of adjusted gross income. This is not a comprehensive definition of income, since it does not take account of many additional items which might be included in the tax base under alternative proposals or other possible changes in the measurement of income. In addition, it does not reflect the income and tax liability of the corporations in which individuals own shares. However, using expanded income probably provides a good indication of how progressive the system would appear if the tax base was more comprehensive.

As shown in Table 2, the present individual income tax system exhibits a substantial degree of progressivity. The average tax rate rises from a negative figure in the bottom class (owing to the refundable earned income tax credit) to about 25 percent in the highest class. The rate in the highest income class is approximately double the average tax rate.

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[3] In 1981, there was about $57 billion of overwithholding and $35 billion of underwithholding. A change that eliminated most of the overwithholding, especially if it did not reduce the underwithholding significantly, could have major effects on budget receipts in the year it first took effect unless it were phased in.

Table 2. Average Tax Rate on Expanded Income Under Present Law, 1985 [1]

[1981 Income Levels]

Expanded income [2] (thousands)	Expanded income (millions)	Tax liability [1] 1985 (millions)	Average tax rate (tax liability divided by income; percent)
Below $5	$30,451	$–300	–1.0
$5 to $10	131,126	4,147	3.2
$10 to $15	175,282	12,780	7.3
$15 to $20	190,239	17,090	9.0
$20 to $30	400,468	42,230	10.5
$30 to $50	502,886	65,205	13.0
$50 to $100	232,062	39,192	16.9
$100 to $200	78,175	17,527	22.4
$200 above	83,626	20,706	24.8
Total	1,824,314	218,576	12.0

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[1] This is preliminary data. Tax liabilities include the refundable portion of the earned income credit, but do not include changes made to individual retirement accounts and ACRS by the Tax Equity and Fiscal Responsibility Act of 1982 for which tax return data are not available.

[2] Expanded income equals gross income plus excluded capital gains and various tax preference items less investment interest to the extent of investment income. The expanded income statistics include all returns and exclude non-filers.

Choosing a pattern of distribution by income class depends primarily on the vertical equity considerations discussed above. As noted before, this is largely a matter of value judgment. Some argue that the present distribution pattern should be preserved in any alternative proposal while others may believe that the present distribution is either too progressive or not progressive enough. In addition, efficiency may be a consideration in the selection of the distribution of tax burdens, because the relatively high marginal tax rates on higher income taxpayers necessary to achieve the desired distribution may result in a significant increase in the inefficiency caused by the system.

E. Achieving Specified Revenue Targets

One of the key decisions which must be made in analyzing or designing a comprehensive tax proposal is the choice of a revenue target. Clearly, if there is substantial base broadening with no changes in marginal tax rates, total revenue will be increased, and if marginal tax rates are lowered without changing the tax base, total revenue will be reduced. Several of the proposals appear to be designed so that the new combination of tax rates and tax base would produce approximately the same revenue as is expected under present law for a chosen fiscal year. However, if a judgment is made that this level is either too low or too high, base broadening and tax rate decisions can be adjusted accordingly.

F. Conclusion

Each of the comprehensive tax proposals under discussion would make changes in at least several of the five areas discussed above. It certainly would be possible to achieve base broadening by itself, although this would change the total revenue raised and the pattern of distribution by income class. Similarly, a proposal could be designed to reduce progressivity in the rate schedules while leaving the tax base, the distribution by income class, and total revenue unchanged. Marginal rates could be reduced or increased, making no changes in the tax base, but total revenue obviously would change. Even though the five areas may be logically distinct, substantial change in any one of these areas appears to bring into consideration other objectives. The balance among these objectives depends on the equity, efficiency, simplicity, and other tax policy considerations discussed in the first part of the pamphlet.

III. ISSUES IN DESIGNING THE TAX BASE

A. Overview

One definition of a person's income is the amount he could potentially consume over a period of time without reducing his wealth. Under this definition, income during a year would equal the person's actual consumption in the year plus the increase in his wealth (i.e., his savings) between the beginning and the end of the year. This, in turn, would equal the sum of wages, interest, dividends and other receipts, minus costs incurred in earning income, plus any appreciation, realized or unrealized, in the value of the person's wealth.

The present income tax base differs from this theoretical "accretion" concept of income in a number of respects. These can be divided into ways in which the basic tax structure fails to correspond to a pure income tax (structural tax issues) and specific tax provisions which are intended to provide incentives for taxpayers to engage in particular activities or to provide relief for particular types of taxpayers (tax expenditures).

B. Structural Tax Issues

Five of the principal structural income tax issues are the following:

(1) The definition of income from capital and the treatment of borrowing during periods of inflation.
(2) The taxation of corporate-source income.
(3) The treatment of noncash income.
(4) The treatment of unrealized income.
(5) The treatment of savings, and whether a tax on consumer expenditures would be more appropriate than an income tax.

This section of the pamphlet discusses these five structural issues.

1. Indexing the definition of income for inflation

Inflation creates a problem for an income tax because it increases the difficulty of defining taxable income from capital and of properly treating borrowing. A proper definition is necessary if ability to pay is judged to be measured by income and if efficiency considerations call for equal tax rates on income from various activities. This problem is most easily seen by considering a case in which a person buys an asset for $50,000, holds it for a period during which the general price level doubles, and sells that asset for $100,000. In reality, the taxpayer has experienced no real increase in his wealth and has no income from the sale of the asset; the purchasing power sacrificed in order to buy the asset is exactly equal to the purchasing power represented by the sale of the asset.

However, under present law, the taxpayer must report a long-term capital gain of $50,000, forty percent of which is included in adjusted gross income.

A similar problem arises in measuring depreciation. In theory, depreciation should be a measure of the real loss of value of an asset during a time period. If a taxpayer buys a building for $50,000, he is presently able to claim cost recovery deductions amounting to $50,000 over an 18-year period. However, if rapid inflation occurs during that period, the purchasing power represented by the cumulative cost recovery deductions will be less than that sacrificed to purchase the building, and real income will not be measured exactly. The same problem arises in inventory accounting when businesses use the first-in, first-out (FIFO) method of accounting in periods of inflation, since increases in the value of inventory from inflation are treated as taxable income even though the increase does not result in any real increase in asset values.

The treatment of debt in periods of inflation also fails to conform to an exact measure of real income. Inflation enables the borrower to repay debt with less valuable dollars, which represents income to the borrower that currently goes untaxed. To the extent that interest payments rise to compensate for anticipated inflation, the additional interest is deductible. Conversely, the erosion of the real value of indebtedness is a cost to the lender that he is currently unable to deduct, even though any additional interest to compensate for inflation is included in taxable income.

It should be noted that the issues discussed here relating to the definition of the income tax base are entirely separate from the effect of inflation in narrowing the real width of the tax brackets and reducing the real value of the personal exemption and the other fixed dollar amounts used to determine tax liability (so-called bracket creep). For the individual income tax for years after 1984, bracket creep was largely eliminated by the indexing provisions of the Economic Recovery Tax Act of 1981.

One way to deal with these definitional problems would be to enact a more comprehensive indexing program in which the definition of income from capital and the treatment of debt would be adjusted for inflation so as to achieve an accurate measure of real income. This would involve the following specific changes: (1) indexing the basis of assets by the rate of inflation for purposes both of computing gain or loss on the sale or exchange of those assets and of computing depreciation, depletion and other capital cost recovery deductions, (2) adopting a new system of inventory accounting in which costs would be indexed for inflation, (3) requiring borrowers to include in taxable income the gain that results when inflation erodes the real value of their debt, and (4) allowing lenders to deduct the loss that results when inflation erodes the real value of debt.

While the tax-writing committees have never considered such a complete indexing program, there has been serious consideration of some of its elements. In its version of the Revenue Act of 1978, the House passed an indexing adjustment to basis for capital gains and losses on corporate stock, real estate, and tangible personal property. In its version of the Tax Equity and Fiscal Responsibility Act of 1982, the Senate passed a similar provision applying to corporate stock and real estate. Indexing basis for purposes of computing depreciation deductions was discussed in the context of depreciation reform in 1980 and 1981.

There is little disagreement that a comprehensive income tax would not reach an accurate definition of income without indexing. However, more comprehensive, exact indexing would add a good deal of complexity to the tax system, particularly the exact indexing adjustments for inventory accounting, borrowing and lending. Even a program of partial indexing, limited to capital cost recovery and measurement of gain and loss, would add some complexity, which might not be worth the effort at sufficiently low rates of inflation.

In place of indexing the definition of income, Congress has adopted several *ad hoc* approaches to alleviating the distortions created by inflation. The last-in, first-out (LIFO) method of inventory accounting is, in most cases, an adequate substitute for a more complicated indexed system. The exclusion for 60-percent of long-term capital gains and the ACRS method of recovering the costs of equipment and structures were both motivated, in some degree, by a desire to offset some of the distortions in income measurement caused by inflation. Furthermore, the distortion caused by the failure of the present system to make inflation adjustments for debt is reduced by the fact that the adjustments made by the borrower and lender would, to some extent, offset each other (and would be completely offsetting if the two had identical marginal tax rates).

These *ad hoc* provisions, however, are themselves deviations from what would be appropriate in a comprehensive income tax and create some inequities and distortions which, to a degree, offset the benefits they provide in reducing the distortions created by inflation. For example, an *ad hoc* adjustment, like ACRS or the 60-percent capital gains deduction, will only be accurate at a single rate of inflation, and actual inflation rates are likely to be different. The present rate of inflation, for example, is significantly lower than the inflation rate at the time both the 60-percent capital gains deduction and ACRS were enacted.

Thus, there is no entirely satisfactory solution to the problem of properly defining the tax base in periods of inflation. Any solution involves trade-offs between complexity, equity, and various kinds of distortions.

2. Taxation of corporate income

Corporate integration

Under present law, corporate-source income is taxed at the corporate level under the corporate income tax. In addition, dividend distributions are taxed under the individual income tax, and increases in the value of corporate stock that result from earnings retention are taxed as capital gains to the shareholder. Clearly, this system does violence to the principle that all income be taxed alike. Dividends may be subject to a combined corporate and individual tax burden as high as 73 percent.[4] Retained earnings bear a

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[4] For example, consider $100 of corporate-source income before taxes. There will generally be a corporate income tax of $46. If the remaining $54 is distributed as a dividend to a taxpayer in the 50-percent bracket, the individual income tax will be $27, for a combined tax burden of $73.

46-percent corporate tax plus a capital gains tax when the shareholder sells his stock. Corporate-source income, therefore, will generally be taxed at the same marginal tax rate as other kinds of income only in the case of corporations with zero marginal tax rates (i.e., negative taxable income or excess credits) who pay out all their earnings as dividends. In other cases, corporate-source income will be taxed more or less heavily than the shareholder's ordinary income.

The present system is held responsible for creating economic inefficiency by distorting several types of business decisions. Shareholders have an incentive to invest in assets other than corporate stock in order to avoid double taxation. Corporations have an incentive to finance their operations with debt rather than equity because interest payments are deductible (and hence not subject to double taxation). Corporations also have an incentive to retain earnings, rather than pay out dividends, to avoid double taxation if they can ultimately distribute that money to shareholders as part of a liquidation, through repurchase of their own shares, or in connection with a takeover, the proceeds from which are usually subject to tax at capital gains rates. These distortions caused by the present system of taxing corporations have been blamed for reducing capital formation and productivity growth, preventing the allocation of capital to its most efficient uses, weakening the nation's financial structure through excessive reliance on debt, and encouraging mergers and acquisitions.

One way to treat corporate-source income would be to tax all of it, dividends and retained earnings, as if it were earned directly by shareholders. This is essentially the way subchapter S corporations are treated today. The corporate income tax could be retained as a withholding tax, for which shareholders would receive a refundable credit on their own tax returns just as they do for the present withholding taxes on wages.

Unfortunately, when applied to large corporations with complex structures, this type of complete integration of the corporate and individual income taxes presents serious technical problems.[5] As a result, much more attention has focused on simply reducing or eliminating the double taxation of dividends, without modifying the treatment of retained earnings. This can be done either through the dividend deduction approach or the shareholder credit approach.

The dividend deduction approach is the simplest way to eliminate double taxation of dividends. Corporations simply would deduct their dividends paid in determining taxable income, in effect exempting from the corporate income tax whatever income is distributed as dividends, leaving that income to be taxed once at the shareholder level.

Under the shareholder credit approach, a shareholder would make two adjustments. First, he would "gross-up" the amount of the dividend included in gross income by the amount of the corporate tax deemed paid with respect to that income. Second, he would claim a refundable tax credit for the amount of the gross-up. If the shareholder credits with respect to a corporation's dividends exceeded the amount of corporate tax actually paid by the corporation, it would have to pay an additional tax to make up the shortfall.[6]

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[5] For example, consider the situations in which two corporations own stock in each other. Neither would know how much income to report until it had heard from the other how much were the other's retained earnings. Also, there would be problems in tracing audit adjustments at the corporate level through to each of the shareholders.

A number of considerations are relevant in choosing between these two approaches. The dividends-paid deduction is simpler. However, the shareholder credit provides flexibility under which, for example, the credit can be denied to tax-exempt organizations and foreign shareholders for whom there is no U.S. double taxation. This would reduce the revenue impact.

The argument for relieving the double taxation of dividends is stronger to the extent that the corporate income tax base is broadened. One problem that arises with the present relatively narrow corporate tax base is that many profitable companies have zero or low marginal tax rates because they use tax preferences, while others have substantial tax liability and are subject to the top 46-percent marginal tax rate. These differences create inequities and distortions between firms, which would be exacerbated if a new deduction for dividends paid or shareholder credit were added to the system. On the other hand, the argument for relieving the double taxation of dividends is weaker to the extent that marginal tax rates in the individual and corporate income taxes are reduced from their present levels, since the size of the distortions caused by double taxation is directly related to these marginal rates. In addition, eliminating double taxation would narrow the tax base and thus preclude further opportunities for reducing marginal rates.

Consistent treatment of corporations and individuals

Another structural issue is the extent to which there should be consistency between the corporate and individual income taxes, both in terms of the tax bases and the tax rates. For example, if certain tax benefits are provided to corporations and not individuals, there may be an incentive to conduct business in the corporate form and there may be inequities and competitive advantages in favor of corporate business. Also, if the corporate tax rate exceeds the top individual tax rate and there is no double taxation of dividends, corporations will have an incentive to pay out earnings as dividends up to the point where their dividends-paid deduction exhausts their taxable income. This would represent a significant change in the pattern of corporate finance.

Deferral of tax on earnings of foreign corporations

Under current law, United States persons who invest directly in foreign countries are subject to current U.S. tax on their foreign income (subject to a foreign tax credit that may offset U.S. tax on that foreign income). U.S. persons who invest in foreign countries through foreign subsidiary corporations generally may defer tax on the undistributed earnings of the subsidiaries until repatriation. Although Congress has enacted exceptions to this general rule,[7] if a controlled foreign corporation's earnings do not arise from certain designated activities, its U.S. shareholders are not currently taxable on the foreign corporation's earnings, but instead defer tax (subject to a foreign tax credit) until distribution of the earnings.

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[6] Under many integration proposals, the amount of the gross-up would be determined by a simple arithmetic formula whereby the shareholder would multiply his dividend by 1.85 regardless of the amount of tax the corporation actually paid. This is derived as follows: assume $100 of corporate pre-tax income. The corporate income tax is $46, leaving $54 to be distributed as a dividend. Thus, if the shareholder multiplies his dividend by 1.85, he will include the full $100 in income ($54x1.85=100). The shareholder's credit, then, would be 85 percent of the dividend, or $46. If the corporation actually paid $40 owing to tax preferences, it would have to pay an additional tax of $6.

A foreign tax credit in general is intended to follow the principle of capital export neutrality—that domestic and foreign investments receive the same U.S. tax treatment. It has been argued that the current system of deferral of the undistributed earnings of U.S.-owned foreign corporations does not comport with that principle, however. By allowing U.S. companies to operate currently in foreign countries under local tax rules rather than U.S. tax rules, deferral can create a U.S. tax preference for foreign investment over U.S. investment in cases where local rules produce the smaller tax. If current investment incentives were reduced in conjunction with a major revision of the U.S. income tax, the significance of this preference would be increased.

Some have argued that repeal of deferral could simplify rules governing the treatment of foreign income and could reduce or eliminate a variety of tax-planning opportunities that arise upon the interposition of a foreign corporation between the taxpayer and foreign source income. These include (1) the ability to manipulate the foreign tax credit that arises when taxpayers conduct some foreign operations directly, and other foreign operations through foreign subsidiaries, (2) the opportunity for U.S. taxpayers to decide when certain income will become subject to U.S. tax, and (3) the incentive for U.S. taxpayers to avoid U.S. tax by undercharging foreign subsidiaries for goods or services.

However, others contend that repeal of deferral could discourage exports, because some foreign subsidiaries of U.S. persons sell U.S. goods abroad and benefit from deferral. Repeal could engender a significant audit burden on the Internal Revenue Service. It has also been argued that repeal would result in unfavorable reactions by foreign countries where U.S. persons form foreign subsidiaries.

3. Noncash income

Income that is received in a form other than cash often presents problems in an income tax, particularly when the cash value of the income is hard to determine. The principal types of noncash income include compensation for services paid as fringe benefits and imputed rent on owner-occupied homes and consumer durables.

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[7] In 1935, Congress required the individual shareholder of each personal holding company (a U.S. corporation earning primarily passive income) to include in income his or her share of the company's undistributed earnings. In 1937, Congress enacted similar rules for foreign personal holding companies. In 1962, Congress required any 10-percent U.S. shareholder of a controlled foreign corporation to include in income (subject to a foreign tax credit) a pro rata portion of the undistributed earnings of the foreign corporation that arise from designated activities (such as passive investment, certain related party transactions, and certain oil-related activities).

Fringe benefits

Present law excludes certain statutory fringe benefits from gross income and, generally beginning in 1985, taxes all other fringe benefits at the excess of their fair market value over any amounts paid by the employee for the benefits.[8] In most cases, the statutory fringes were intended by Congress as tax incentives for employers to provide compensation in particular ways, and some of the statutory provisions contain restrictions designed to carry out Congress' intent that these fringe benefits should be widely available (e.g., coverage requirements for qualified pension plans). In other cases, the statutory fringes were intended to codify established practices where business reasons, other than simply providing compensation, were adduced for employers to encourage employees to use the products they sell.

Under the bills discussed here, the tax base would be broadened by repealing some of the present exclusions for fringe benefits. These benefits may be difficult to tax in certain situations. Issues that are often encountered with respect to fringe benefits include the valuation of the benefit (on the basis, e.g., of fair market value or employer's cost), the allocation to individuals of benefits made available to employees as a group,[9] and consistent treatment of one large benefit with various smaller benefits that aggregate to the same value but involve much more effort to account for. In selecting the treatment of fringe benefits, the problems of inexact and complex valuations would have to be balanced against the equity and efficiency advantages of a broader tax base.

Imputed income

The two principal types of imputed income are rent on owner-occupied homes and consumer durables. It has been argued that a homeowner, under a pure income tax, would be treated as someone in the business of renting his house. He would report as income the fair market rental on the house (imputed rent) and deduct all the costs associated with the house, including interest, taxes, utilities and depreciation. Under present law, imputed rent is not taxed, deductions are allowed for interest and taxes, and deductions are denied for utilities, depreciation and most other costs associated with homeownership. Thus, the tax preference for homeownership equals the imputed rent minus the nondeductible costs.[10] Consumer durables are treated the same way: no imputed rent is included, but a deduction is allowed for "consumer" interest and taxes.

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[8] The statutory fringe benefits excluded from gross income are group-term life insurance (sec. 79), a $5,000 death benefit exclusion (sec. 101(b)), accident and health plan contributions (sec. 106), the rental value of parsonages (sec. 107), meals and lodging furnished for the convenience of the employer (sec. 119), prepaid legal services (sec. 120), van pooling services (sec. 124), dependent care assistance (sec. 129), certain in-kind benefits and cash payments to military personnel, miscellaneous benefits (sec. 132), qualified pension plans (sec. 401), and incentive stock options (sec. 422A). However, the employer is denied a deduction for the bargain element of incentive stock options.

[9] Allocation would not be necessary in a flat-rate system with the corporate tax rate equal to the individual rate because businesses could simply be denied a deduction for certain fringe benefits, which could be excluded at the individual level.

[10] This is not the way homeowner preferences are treated in the annual tax expenditure budgets published by OMB, CBO, and the Joint Committee staff. In those documents, the tax expenditure for homeownership is defined as the mortgage interest and property tax deductions, on the assumption that taxing imputed rent is not a serious possibility. Only for a house which is entirely debt-financed and whose value is equal to its purchase price will the two measures of the preference be similar

Few people seriously propose taxing imputed rent on owner-occupied homes or consumer durables because valuing the rentals would be extremely complicated and there is a public policy to encourage homeownership.[11] Rather, proposals to scale back the homeowner and consumer durable preferences generally take the form of limits on, or repeal of, the mortgage or consumer interest and property tax deductions. However, these proposals are not entirely free from problems of their own. Unless it were accompanied by repeal of the deduction for other nonbusiness taxes, repeal of the property tax deduction could be viewed as discriminating against those States and localities that rely disproportionately on the property tax. Limits on, or repeal of, the mortgage and consumer interest deductions tend to cut back the preference in proportion to the extent that the taxpayer finances his home or durables with debt rather than equity, and such a nonuniform scaling back of preferences may make the system less, rather than more, equitable. Furthermore, there is a practical problem that money is fungible and that there is no real economic distinction between mortgage and consumer interest, on the one hand, and other kinds of interest that are legitimate deductions in a tax on net income, on the other. However, the tax system has traditionally made a distinction between personal and business expenditures.

These types of considerations lead to other proposals for reducing the distortions and inequities associated with the treatment of interest and homeownership. For example, it has been suggested that all interest deductions be limited to investment income. None of the bills discussed in the Appendix attempt to tax imputed rent on homes or durables; however, several repeal or limit interest and tax deductions.

4. Unrealized income

Some types of income consist of increases in the value of assets prior to the time when the taxpayer actually receives the income, such as by selling or exchanging the assets. Taxing such unrealized income would present two problems: (1) in some cases, it may be difficult to value the asset in order to measure the income properly; and (2) the taxpayer may not have access to cash with which to pay his tax.

Capital gains and losses is the area where unrealized income creates the most serious problems. Assuming that taxing gains and deducting losses as they accrue is ruled out because of the valuation and liquidity problems,[12] the only alternative is to tax them when realized; that is, when the asset is sold or exchanged or some other recognition event occurs. Because selling an asset is generally within the taxpayer's discretion, a tax on realized gains gives taxpayers an incentive to defer realization in order to postpone the tax.[13] This, in turn, has been a justification for providing preferential treatment for long-term capital gains, the argument being that full taxation of such gains at high ordinary rates would discourage sales of appreciated property to such an extent that it would be counterproductive. Moreover, the fact that realization of gains and losses is discretionary has been the justification for imposing *ad hoc* limits on the deductibility of capital losses.[14] Without such limits, taxpayers who own a variety of assets could realize their losses and defer their gains, thereby escaping tax despite the fact that they had substantial real income. Thus, the treatment of capital gains deviates in a number of respects from what would exist in a pure income tax.

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[11] However, it should be noted that the United Kingdom taxed imputed rent on homes for over a century—from the beginning of its income tax to 1963. By that date, the property-value assessments on which the determination of imputed rent was based had been rendered obsolete by inflation, and the U.K. decided to exempt imputed rent rather than update the assessments.

[12] Some also believe that there would be a constitutional problem with taxing unrealized gains. Canada recently adopted an elective system for taxing corporate stocks that involves taxing gains as they accrue.

In recent years, Congress has moved towards taxing some unrealized income, generally in areas where the valuation and liquidity problems were not significant, the income tended to be received by sophisticated taxpayers, and there was serious potential for tax avoidance. In 1969, Congress required periodic inclusions of discount income on corporate original issue discount bonds.[15] In 1981, Congress adopted a mark-to-market system of accrual taxation for commodity futures contracts, and in 1984 extended that system to many options transactions.

5. Tax treatment of saving and consumption taxes

A number of analysts believe that the individual income tax should be replaced by a tax on consumer spending, so that the types of savings currently in the tax base would be exempt. In general, their analysis is that national welfare would be increased if greater savings could be funneled into greater investment that ultimately leads to higher levels of production. Two taxes that have been discussed in this regard are the consumed income tax and the value added tax.

Individuals would continue to be the tax filing units under a consumed income tax. It would not be necessary for taxpayers to add up all their purchases of consumer goods and services. Rather, a consumption tax could be implemented through several modifications of the income tax, which make use of the arithmetical result that a person's after-tax income is either spent on consumption or saved. Thus, a consumption tax base could be implemented by starting with an income tax base, allowing taxpayers to deduct all purchases of assets during the year, all tax payments, and all repayment of debt, and requiring them to add to the tax base the proceeds from all sales of assets and from all borrowing. A graduated rate structure could be applied to this base to produce a progressive tax, like the current income tax. Moreover, because a consumed income tax, like the current income tax, would be a personal tax, any additional personal circumstances (such as family size) which may be deemed relevant to equitable taxation could be taken into account. Although there is a history of academic analysis of the consumed income tax, it appears that only India and Sri Lanka have had experience with implementing it. Both countries have since repealed their consumed income tax.

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[13] Furthermore, the present rule under which an heir steps up the basis of inherited assets to the fair market value for estate tax purposes means that holding onto appreciated property can ultimately result in escaping any income tax on the appreciation.

[14] Currently, individuals may deduct capital losses against capital gains and up to $3,000 of ordinary income. Unused capital losses may be carried forward. Corporations may not deduct capital losses against ordinary income. Their carryforward is limited to 5 years, but they get a 3-year carryback.

[15] In the Tax Equity and Fiscal Responsibility Act of 1982, the inclusion formula was revised and periodic inclusion was extended to noncorporate bonds and stripped coupon bonds. The Tax Reform Act of 1984 further extended periodic inclusion to certain debt obligations previously exempted from the 1982 provisions.

Businesses would be the tax filing unit under a value added tax. The value added by a business, and the base of the consumption-type value added tax, is the difference between its sales proceeds and the cost of raw materials, semi-finished goods, capital goods, and other items that it has purchased from other businesses. Thus, if a business has sales of $100 and purchases $80 of goods and services from other businesses, its value added is $20. This will equal the sum of the wages and salaries it pays for the use of labor, the interest it pays for the use of capital, and its profits. Under one method of tax computation, the business would apply the tax rate to this base and remit the tax. Under an alternative method, generally used in Europe, the business would compute a tentative tax on sales proceeds and a tentative tax credit for purchases from other businesses and then remit the difference. Since the value added tax on all sales to other businesses would be offset by subsequent tax credits, the only value added tax that matters from the standpoint of overall revenues is the tax collected at the retail level, where there is no offsetting credit. (Thus, some argue, a third alternative would simply be to impose a national retail sales tax.) Exporters would claim a rebate for the value added tax they paid when they acquired the goods for export, and importers would pay tax on the value of imported goods.

Conceptually, there are several types of value added taxes, differentiated by their treatment of the cost of capital goods. The consumption-type of value added tax is generally in use in European countries, where standard tax rates cluster between 15 and 20 percent. In many countries, exemptions or reduced tax rates are provided for numerous items—food, housing rent, medical services, water and newspapers are examples—while tax rates above the standard tax rate may apply to luxury items. In many cases, these value added taxes succeeded other consumption taxes, such as a turnover tax on all sales, a manufacturers' sales tax, a wholesalers' sales tax or a retail sales tax. The turnover tax has been criticized for effectively imposing a higher tax on value added early in the production and distribution process (because it is taxable again in later stages), thus providing incentives for businesses to integrate vertically. A manufacturers' or wholesalers' sales tax would alleviate this problem, because they are single-stage taxes; however, by failing to tax value added at the retail stage, such taxes create distortions against products where little value added occurs at the retail level.

Consumption taxes may be levied on a more limited basis for the purposes of raising revenue, discouraging consumption of specific products; or financing public expenditures closely related to the consumption of specific products. For example, the United States currently imposes taxes on the consumption of communications services, alcoholic beverages, cigarettes, and highway motor fuels. A proposal to tax energy consumption, discussed in the Appendix, has also been considered.

Effect on incentives

Proponents of the consumption tax base argue that the income tax, by taxing income from capital, encourages taxpayers to consume their income now rather than save for future consumption and that a consumption tax would not distort this decision. Advocates of the income tax do not generally dispute this proposition but argue that the effect is not large enough to justify a change, that society can increase its saving by reducing government budget deficits, that other economic inefficiencies would be caused by the high marginal tax rates which would be necessary if saving were excluded from the tax base and that, in any event, the emphasis on savings (rather than consumption) as the key to economic growth is misplaced.

Equity

Advocates of the consumption tax also argue that such a tax would be more equitable. Consider a simple example in which two taxpayers each earn $100. One consumes his after-tax income immediately, while the other invests it at 10 percent and consumes the proceeds the next year. Under an income tax with a 50-percent rate, both taxpayers would pay $50 in the first year, but the saver would pay an additional $2.50 on his $5 in the second year. Under a consumption tax, the taxpayer who spends in the first year would pay $50 that year, while the saver would pay $55 in the second year; that is, the present value of their tax burden would be the same. (Under an income tax limited to personal service income, they both would pay $50 in the first year, so that their tax burdens would be identical in both years.) Proponents of a consumption tax argue that these two taxpayers are similarly situated because they have exactly the same opportunities over the two-year period and that it is equitable for them to pay the same tax either directly (as in an income tax on personal service income) or in present value terms (as in a consumption tax).

Critics of the consumption tax approach argue that a year-by-year comparison is more appropriate than a lifetime perspective and that, from this standpoint, the two taxpayers are only similarly situated in the first year, with the saver better off in the second year and, hence, able to pay more tax that year. They also argue that the equity argument in favor of the consumption tax hinges on treating bequests as consumption and taxing them as such when a person dies. This, however, would be a controversial aspect of any consumption tax, since the bequests would be taxed again when consumed by the heirs. Moreover, taxpayers who are consuming more than their income because they are facing hard times, like the unemployed, would fare worse under a consumption tax than under an income tax, which may not be considered a fair result. Other taxpayers whose burdens would be higher under a consumption tax would include the elderly and parents putting their children through college. Perhaps most fundamentally, critics doubt that vertical equity in the distribution of tax burdens, gauged relative to the ability to pay taxes, can be achieved under a consumption tax.

Problems with the income tax

One argument for a consumption tax is that it would moot many of the questions that make it difficult to structure an income tax. A consumption tax would require no special rules for indexing the definition of income from capital and borrowing for inflation, capital gains and losses, depreciation, inventory accounting, or unrealized income. However, some structural problems with the income tax, like the treatment of many fringe benefits and of imputed income, would remain. Moreover, a consumption tax could create some new problems, like the treatment of gifts and bequests and the multitude of distinctions necessary to implement any exemptions or differential tax rates (as between necessities and luxuries, for example), that may be deemed necessary for furthering equity goals or other social considerations.

Marginal tax rates

A consumption base would be narrower than a comprehensive income base (although not necessarily narrower than the present income tax base), and higher-income people tend to save a larger percentage of their income than others. Therefore, to raise a given amount of revenue with a given degree of progressivity, the consumption base would require higher marginal tax rates than an income base. These higher rates would increase the ill effects of whatever distortions remained in the consumption tax system.

Transition issues

There would be difficulties in effecting a transition from an income tax to a consumption tax. It would be unfair, for example, to tax consumption out of wealth which had been accumulated out of after-tax income under the prior income tax. A transition rule to prevent such double taxation, however, such as allowing taxpayers to deduct the basis of assets held on the effective date of the consumption tax in order to grandfather consumption out of previously taxed income, would have a large revenue loss in the early years of the tax and would virtually exempt many wealthy people from tax for a period of years.

C. Tax Expenditure Provisions

In addition to addressing the structural problems outlined above, a thorough review of the income tax would have to confront the variety of special provisions that have been added to the law over the years to provide incentive for particular kinds of activities or to provide relief to particular kinds of taxpayers. There are about 100 such tax expenditure provisions, more than one-quarter of which have been enacted since 1976. They include exclusions for certain kinds of income, deductions for costs other than the costs of earning income, tax credits, and tax deferral provisions.

In this regard, there are several important considerations. Tax expenditures have the advantage that they can be plugged into an administrative mechanism through which the government already communicates with a large number of its citizens. Tax expenditures do not generally require separate or detailed application forms, and they are received relatively quickly. On the other hand, most tax expenditures make the tax system more complex for the taxpayer and also reduce the extent to which the public perceives the system to be equitable. In addition, if the tax expenditure takes the form of an exclusion or deduction in a system with progressive rates, it provides a higher rate of subsidy to high income than to low income taxpayers, a result which may be undesirable. Unless the tax expenditure is refundable, it will not be available to taxpayers with no tax liability, and if such taxpayers are corporations, they may have a purely tax-motivated incentive to merge with taxpaying units. Tax expenditures may also cause administrative problems for the agency administering the tax system, which may be required to deal with policy issues outside its normal area of expertise. Tax expenditures have also been criticized for being, in effect, entitlement programs which are not reviewed each year as part of the appropriations process and not subject to the controls which the budget process imposes on new entitlement authority. (However, in recent years Congress has tended to put termination dates on many new tax expenditure provisions to encourage periodic review of them.) It has been argued that, as a practical matter, some tax expenditures would not have been adopted or would have been adopted in a much more limited form, if provided as budget outlays.

Analysis of tax expenditures generally involves two issues. First, whether the nontax policy goal accomplished by the tax expenditure is worth the lost revenue and whatever other tax policy goals are being sacrificed must be decided. This is likely to be based on efficiency (benefit-cost), distributional and administrative considerations similar to those discussed in the first part of this pamphlet. The second decision is whether other approaches to achieve the nontax policy goal, such as spending or regulation, would be preferable. After reviewing tax expenditure provisions as part of an overhaul of the income tax, Congress could decide that the nontax policy goals of certain tax expenditures should be accomplished with spending programs, in which case not all the revenue raised by broadening the tax base would be available to finance tax rate reductions. For example, if the charitable deduction were repealed, Congress might want to enact a spending program under which the federal government matches private contributions to charitable organizations. Conceivably, this matching grant program would cost as much as the revenue loss from the deduction.

The bills discussed in the Appendix would repeal many or most of the tax expenditure provisions and use the resulting revenue gain to finance tax rate reductions.

IV. ISSUES IN TRANSITION TO A NEW SYSTEM

A. General Transition Issues

Hypothetically, if a comprehensive income tax were enacted and made effective overnight, taxpayers would experience sharp swings in after-tax income, wealth, and cashflow. Contracts and investments which were profitable under the old tax rules could be rendered unprofitable. Taxpayers who made tax-preferred investments under the old rules could experience an abrupt decline in current (after-tax) income and in wealth—the capitalized value of future income—relative to taxpayers holding ordinary investments. This reduction in taxpayer wealth might be regarded as particularly inequitable when the shelter was designed and encouraged by Congress in order to achieve certain social or economic objectives, as in the case of tax-free municipal bonds. On the other hand, windfall losses due to the elimination of unintended tax avoidance practices would not necessarily be viewed as undesirable tax policy.

Sudden changes in taxpayers' after-tax incomes may also create a perception of inequity because taxpayers may find it difficult to adjust their spending patterns to the new conditions.

B. General Transition Rule Options

The goals of wealth protection and time-to-adjust can be achieved by two general types of transition rules: (1) grandfather clauses and (2) phase-in provisions. Grandfather clauses permit (or require) contracts and investments, initiated under the old tax rules, to be governed by the old law. If the grandfather clause is available on an elective basis, the taxpayer can avoid being made worse off as a result of the tax change; while if the clause requires old-law tax treatment, then some windfall gains, due to the tax law change, are also eliminated. A grandfathering provision may apply to all eligible investments or be limited to owners of the investment at the time the change in tax rules was first considered or enacted. If the clause is limited to the original owner, then taxpayers may not be protected against windfall losses if the investment is sold to another, ineligible, investor. If the investment, rather than the owner, is grandfathered, then the owner is protected against a windfall loss even if the investment is sold after the tax law change; indeed, since the grandfather clause creates a limited supply of old-law investments, original owners may reap windfall gains under such a rule. Also, if a tax change has been widely anticipated for a long time prior to enactment, asset values may reflect the likelihood of the change, and a grandfather rule may lead to windfall increases in asset values.

Phase-in provisions may be used to delay the effect of new tax rules on both existing and new investments. With respect to existing investments, a phase-in rule provides temporary and partial protection of asset values compared to an elective grandfather clause. The longer and more gradual a phase-in rule, the more similar it is to a grandfather clause. In the limit, if the new tax rules are only phased-in after existing investments are scrapped, then the phase-in provision is precisely equivalent to a grandfather clause for existing investments. However, since many investments, such as homes, last 30 years or more, very long phase-in rules would be required to effectively grandfather all existing investments. With respect to new assets, the effect of a phase-in period is primarily to slow the rate of transition, thereby allowing taxpayers adequate time to adjust. Phase-in provisions may gradually change tax laws or simply provide a grace period in advance of a major change in rules. Both a gradual phase-in and a grace period moderate wealth changes on existing assets and provide taxpayers time to adjust.

Criteria for selecting between the alternative grandfathering and phase-in approaches include the following: (1) effectiveness in achieving the twin goals of moderating adverse wealth effects and providing taxpayers adequate time to adjust, (2) absence of incentives for taxpayers to make non-economic, tax-motivated investments during the transition period, and (3) simplicity of transition rules. It is unlikely that any one transition rule best satisfies all three criteria, so that the choice among alternatives requires judgement about the relative importance of these objectives.

C. Specific Issues in the Transition to a Comprehensive Income Tax

This section surveys some of the specific transition problems associated with eliminating some of the major exclusions and deductions.

Exclusions

Some of the most important exclusions in the individual income tax are the exclusions for (1) transfer payments like social security and public assistance, (2) fringe benefits, and (3) 60 percent of capital gains. Including transfer payments in taxable income would reduce the benefit from these payments to those recipients whose income exceeds the level at which people begin to pay tax. It would be possible to readjust benefit schedules to compensate for inclusion in taxable income for taxpayers with a particular marginal tax rate, but this could take Federal and State governments a period of several years. To allow time for such compensating legislation, it may be appropriate to delay the effective date of repeal of the exclusion for transfer payments or to phase it in. To the extent benefits are not readjusted for inclusion or the taxpayer's marginal tax rate is higher than the rate on which the benefit readjustment was based, current and future recipients would be adversely affected. This could create a problem, such as for people who have already retired or expect soon to retire on the basis of a certain level of tax-exempt retirement benefits (like social security). One possible response to this problem would be to grandfather retirement benefits that accrued prior to the change in the law. A drawback to grandfathering accrued retirement benefits is the difficulty of distinguishing retirement benefits accrued before the rules changed from those accruing afterward. For this reason it might be simpler to tax a gradually rising percentage of retirement benefits. This phase-in approach would tax least the benefits of those taxpayers nearest to retirement.

Including fringe benefits in taxable income would reduce the effective salary of employees now benefiting from fringes. Taxpayers presumably would respond by substituting cash wages for some of the less desirable fringes, but this could take time (e.g., to renegotiate contracts). Moreover, there will be many cases in which workers have accrued fringe benefits where realization has not taken place. The simplest transition rule would be to allow a grace period of one or more years in which realization of accrued fringe benefits could take place under the old tax law and taxpayers would have time to modify compensation arrangements.

Including 100 percent of capital gains in taxable income (without reducing tax rates) would reduce the value of many assets. The reduction in value would be largest for assets whose return is disproportionately in the form of capital gains (e.g., gold and homes). While accrued but unrealized capital gains could be grandfathered by applying the new rules only to appreciation occurring after the effective date (a fresh start), this would require the segregation of assets acquired prior to the law change, and measurement of the market value of these assets. This approach was used when the original income tax was enacted in 1913 and when carryover of basis was enacted in 1976, but it created difficulties each time. An alternative approach would be to provide a grace period during which accrued capital gains could be realized under the present tax law. This, however, would give taxpayers an incentive to sell assets during the grace period, thereby distorting decisions. A third approach would be to retain existing law for assets owned on the effective date, but this could discourage sales of those assets. If tax rates are substantially lowered at the same time the capital gains exclusion is eliminated, the effective rate of tax on capital gains may not increase as a result of comprehensive income tax reform, which may reduce the need for transition rules; however, there still could be declines in the values of assets whose return consists disproportionately of capital gains.

Itemized deductions

The most important itemized deductions in the individual income tax are the deductions for interest, State and local taxes paid, charitable contributions, and medical expenses.

Eliminating the deduction for mortgage interest would significantly increase the tax liability of most homeowners as well as reduce the market value of most homes. Grandfathering interest paid on existing home mortgages would protect recent homebuyers from an increase in tax liability but would not prevent the present owners of the housing stock from suffering a loss in property value. To fully protect homeowners, old-law treatment would have to be accorded to the existing stock of housing in perpetuity. The transition problems associated with housing are especially difficult because housing is extremely durable and represents a large portion of taxpayer wealth. One possible transition rule would be to allow existing homeowners to take a deduction or credit for the estimated reduction in property value due to the tax law change. While this would compensate the losers from eliminating the mortgage interest deduction, it would be difficult to estimate accurately the monetary loss. Alternatively, a phase-in could moderate the likely decline in home prices.

Elimination of the deduction against Federal income tax for certain kinds of State and local taxes paid would increase the tax liabilities of itemizing taxpayers who pay high State and local taxes. This would put some pressure on State and local governments to change their mix of tax revenues. Therefore, a grace period could be considered to give State legislatures time to make the appropriate adjustments.

Elimination of the charitable contribution deduction could reduce the level of charitable giving, perhaps substantially. This would reduce the revenue of organizations that rely on charitable contributions and could force a reduction in their programs and outlays. A phase-in period would provide time for charitable organizations to develop alternative sources of revenues and to bring expenditure plans in line with income.

Elimination of the medical expense deduction would increase the tax liability of itemizing taxpayers whose unreimbursed medical expenses exceed 5 percent of adjusted gross income. A phase-in or grace period could be helpful to allow taxpayers time to raise their medical insurance coverage.

The number of transition problems which arise in the adoption of a new system are numerous and often are different for the different provisions being changed. These transition problems should be considered one-by-one as discussions of comprehensive tax reform progress.

APPENDIX

SUMMARY OF COMPREHENSIVE TAX BILLS AND PROPOSALS IN THE SENATE DURING THE 98TH CONGRESS

Overview

Several bills which address comprehensive income tax reform have been introduced in the Senate during the 98th Congress. Generally, these bills would broaden the income tax base by repealing or modifying tax expenditures and would lower and flatten the individual income tax rate schedule. A number of these legislative initiatives also address structural issues in the current income tax system including the marriage penalty, the treatment of saving, the effect of inflation in defining income from capital, and the relationship between the corporate and individual income taxes. These comprehensive income tax bills range along a spectrum from those with a very broad base and a low flat rate to less broadly based taxes with moderately progressive rates. A brief description of these proposals follows.

Also during tne 98th Congress, the Finance Committee considered a proposal, summarized below, for imposing a 2.5-percent tax on energy consumption.

Summary of income tax proposals

S. 557 (Senators DeConcini and Symms) would impose a flat 19-percent tax on essentially all income of individuals and businesses. Immediate expensing would be allowed for capital expenditures for business purposes. Businesses could carry net losses forward without limitation to offset taxable income in future years, and these losses would be augmented annually by interest until so utilized. A standard deduction of $4,100 for single taxpayers ($6,700 for married persons filing jointly) and an $810 exemption for each dependent would be allowed. These amounts would be indexed for inflation.

S. 1040 (Senator Quayle), the SELF-Tax Plan Act of 1983, would tax the income of individuals at graduated rates ranging from 14 to 28 percent and the income of corporations at the flat rate of 25 percent. The bill would generally repeal all exclusions and deductions from gross income and all credits against income tax. This repeal would be governed by the following principles: (1) deductions should be allowed for ordinary and necessary business expenses; (2) income earned in a trade or business should be taxed only once; (3) no individual should be taxed twice on social security or other retirement contributions; and (4) the marriage penalty should be eliminated. A standard deduction of $6,000 for single taxpayers

($10,000 for married persons filing jointly) and a $1,000 personal exemption would be allowed.

S. 1421 (Senator Bradley and others), the Fair Tax Act of 1983, would tax the income of individuals at graduated rates ranging from 14 to 30 percent and the income of corporations at the flat rate of 30 percent. The individual income tax would be structured as a 14-percent base tax on taxable income, supplemented by a graduated surtax, at rates of 12 and 14 percent, on adjusted gross income in excess of $25,000 for single returns and $40,000 for joint returns. The standard deduction would be increased to $3,000 for a single taxpayer ($6,000 for married persons filing jointly) and the taxpayer's personal exemption would generally be increased to $1,600. The base of the individual income tax would be broadened by repealing numerous exclusions and deductions, including those for dividends, interest on industrial development and mortgage subsidy bonds, income earned abroad, two-earner married couples, State and local sales taxes, unemployment compensation, increases in the cash surrender value of insurance policies, the special treatment of capital gains, certain employer-provided insurance benefits, and interest (other than housing interest) in excess of net investment income. Income averaging and indexing of rate brackets would be repealed. All nonrefundable tax credits other than the foreign tax credit would be repealed. All income of controlled foreign corporations would be currently subject to U.S. tax in the hands of their U.S. shareholders. New cost recovery systems designed to measure the taxpayer's loss of economic value would apply to depreciable and depletable property, and amortization periods for certain expenditures would be lengthened. Corporate deductions for charitable contributions would be limited to 50 percent of the contributions.

S. 1767 (Senator Mitchell), the Personal Income Tax Reform Act of 1983, would tax the income of individuals at graduated rates ranging from 12 to 36 percent. The bill would not amend the corporate income tax. The standard deduction would be increased to $4,600 for married persons filing jointly and the taxpayer's personal exemption would generally be increased to $1,500. The individual income tax base would be broadened by repealing most of the exclusions and deductions that would be repealed under S. 1421 (summarized above). S. 1767 would repeal deductions for nonitemized charitable contributions and theft or casualty losses. Income averaging would not be allowed. Nonrefundable tax credits other than the foreign tax credit would not be available to individuals. The bill also would impose a 12-percent tax on the income of individual retirement accounts, qualified pension and profit-sharing plans, and stock bonus plans.

S. 2158 (Senator Hatfield), the Simpliform Tax Act, would tax the income of individuals at graduated rates ranging from 6 to 30 percent. The bill would not amend the corporate income tax. Under the bill, there would be no standard deduction and joint filing by married persons would not be permitted. The general approach of the bill is to repeal or make unavailable to individuals many exclusions, deductions and nonrefundable credits, and to reinstate the benefits of the personal exemption and certain itemized deductions in the form of income tax credits. For example, the current personal exemption would be converted into a $250 credit, which is equivalent to a $1,000 exemption at a tax rate of 25 percent. The amount of this credit would be indexed for inflation. A 15-percent credit (up to $1,000) would be allowed for home mortgage interest in excess of 1 percent of adjusted gross income. Likewise, a 15-percent credit (up to $1,000) would be allowed for local taxes in excess of 1 percent of adjusted gross income. Similarly structured credits, but with different percentages and without a cap, would apply in the case of medical expenses and charitable contributions. The basis of capital assets would be indexed for inflation for purposes of determining gain or loss, and the partial exclusion of capital gains would be repealed.

S. 2600 (Senators Kasten and Hatch), the Fair and Simple Tax Act of 1984, would tax the income of individuals at a single rate of 25 percent and the income of corporations at graduated rates of 15 or 30 percent. The standard deduction would be raised to $2,700 for single taxpayers ($3,500 for married persons filing jointly) and would be indexed for inflation. The personal exemption would be increased to $2,000, but additional exemptions allowed under present law for the elderly and the blind would be eliminated. The earned income credit would be reduced, but a new exclusion for 20 percent of earned income (up to the social security maximum wage base, and phasing out thereafter) would be allowed. Numerous exclusions, deductions and credits, including the investment tax credit, would be repealed or restricted. Income averaging would be repealed. The basis of capital assets would be indexed for inflation for purposes of determining gain or loss. For individuals, the partial exclusion of capital gains would not be available with respect to indexed assets, but capital losses would be fully deductible against ordinary income and excess losses could be carried forward. The tax rate on corporate capital gains under the current alternative tax would be reduced to 20 percent. Depletion deductions generally would be determined under the Accelerated Cost Recovery System.

Senator Roth has announced a proposal for comprehensive reform of the individual income tax with emphasis on encouraging savings and investment. The proposal does not address corporate taxation. Under this proposal, graduated tax rates would range from 15 to 30 percent. The standard deduction would be increased to $3,000 for a single taxpayer ($6,000 for married persons filing jointly) and the personal exemption would be $1,000 per person. These amounts and the tax brackets would be indexed for inflation. The majority of current exclusions and tax credits would be repealed. Itemized deductions would be limited to charitable contributions, medical expenses over 10 percent of adjusted gross income, and home mortgage interest. In the area of savings and investment, a new super savings account for financial assets would replace IRAs and immediate expensing of most personal property would replace depreciation. With respect to the super savings account, contributions would be deducted from taxable income, earnings excluded, and withdrawals included. Withdrawals could occur at any time and for any purpose, without penalty. Net contributions would be limited to $10,000 per year for single taxpayers and $20,000 per year for married persons filing jointly.

Tax on energy consumption

During the 98th Congress, the Finance Committee considered a proposal for imposing a tax on the sale of the major sources of energy consumed in the United States. Under that proposal, taxable energy sources would include petroleum, natural gas, natural gas liquids, coal and electricity. Exemptions would be allowed for (1) energy and energy sources exported from the United States, (2) fuel used to generate electricity, (3) fuel used to produce or transport other fuel, and (4) certain oil and gas received as in-kind royalties.

The tax would be structured to achieve the results of a uniform 2.5-percent tax on the average price of energy sources sold for final demand. The objective of the ad valorem approach is to minimize the impact of the tax on the relative prices of the different energy sources and hence on users' choices among them. However, to ease administration and compliance, the tax would not be administered as an ad valorem tax; rather, separate tax rates for the various energy sources would be provided in terms of dollars per commodity unit, based on nationwide average prices during the preceding period. Moreover, the taxable sale of each energy source would be set at that point in the production and distribution chain which minimizes administrative and compliance costs. For example, with respect to oil, the tax would generally be imposed on the sale of refined petroleum by the refiner.

STATEMENT OF SENATOR DOLE, FINANCE COMMITTEE HEARINGS ON MAJOR TAX REFORMS

Today the Finance Committee begins a review of the issues raised by proposals to overhaul our tax system. These hearings are intended to give us a better understanding of the implications of major reforms from the standpoint of tax, social, and economic policy. This is only a beginning: There are many individuals and organizations who would like to be heard on this subject, and while we can accommodate a small number now, we will do our best in future hearings to hear everyone—we need to hear as wide as possible a range of opinions and perspectives on this subject, because we are talking about fundamental changes.

During these hearings we hope to begin to establish a framework to guide further deliberations on restructuring the tax system. We can do that by clearly formulating the basic options, by developing the facts and figures necessary to informed decisions, and to pinpoint the technical and practical problems that will have to be dealt with if we want to modify the tax system in a major way. Our witnesses are prepared to help us do all of that. In addition, the Treasury Department at the request of the President is examining the issue in some detail, and we hope they will be prepared to make specific recommendations later this year.

BASIC CHOICES

At the outset, I would like to outline some of the basic choices we have before us in connection with the tax reform issue. Some of these choices are simply matters of trying to formulate the best tax policy; some of them are primarily decisions about economic policy; and others are really political decisions, or decisions about what is best for our society.

For example, we have to decide whether significant progressivity in rates is desirable—as under the present system—or whether everyone should pay the same proportion of income in taxes. The answer to this question will depend in part on your view of how important the principle of progressivity is to maintaining popular support for the tax system. The answer also will depend on some simple facts: How progressive is the present system, when you take into account the distribution of tax preferences available under present law, particularly deductions that tend to favor those in higher rate brackets.

We also have to determine how much a gain in simplicity and economic efficiency can be made by moving to a streamlined low-rate or flat-rate structure or to a system that taxes consumption. Defining income is always a source of major complexity, and cutting out tax preferences as such does not deal with that problem. A large zero bracket, if it were adopted as part of a restructuring of our tax system, could provide significant gains in simplicity by reducing the number of itemizers. Again, however, we would need to evaluate the impact of such a change on the distribution of the tax burden and in terms of economic efficiency. And consumption taxes demand the same sort of scrutiny.

There are a number of specific ways in which a lower-rate or consumption-based tax system might be structured. A single rate could be applied, as some propose, to a comprehensive income base. This would mean everyone paying the same proportion of income in tax, with changes in the types of things we have usually included in income: Items such as social security and retirement benefits, among others. Alternatively, rates could be significantly reduced and the base broadened by eliminating a range of tax preferences, but without going all the way toward a single rate with a comprehensive base. These two basic options can be varied, in addition, by including in either a large zero bracket: Guaranteeing a degree of progressivity and protection for lower-income taxpayers, with some gain in simplicity as well from reducing the number of itemizers, assuming the option of retaining some deductions is chosen. We could also consider a flat-rate tax on a less comprehensive income base; preserving some basic tax preferences that have wide support, but at the same time presumably requiring a higher rate to generate the necessary amount of revenue.

In the case of a tax based on consumption, the questions are whether to make it progressive, and how, whether to impose a tax on goods or their production, or just to exempt from tax everything that goes into saving; and whether to exempt certain necessities of life in either case.

What it comes down to is a choice of ways to proceed. Everyone wants greater equity in the Tax Code, and a simpler system, and a tax system that promotes—or at least does not inhibit—economic activity. Choosing the system that best balances each of these goals is not easy, however: And deciding how to move toward a better system may be the most difficult choice of all. There is no point in making a change unless we make a big improvement. So far that case has not been proven for any of the major proposals on the table.

HOW TO PROCEED

The ways in which we might proceed seem, to this Senator at least, to be fairly straightforward. First, we could continue to work through the Tax Code on an item-by-item basis and make decisions about what should go or be modified and what should be preserved: In other words, further base-broadening and tax reform efforts comparable to those included in this year's Deficit Reduction Act. This approach could bring substantial gains in equity and simplicity over time, but it would not necessarily involve the kind of fundamental rethinking of our tax structure that many people seem to want.

Instead, we might do as some are urging, and agree on a major revision of the tax system in the direction of lower rates, a broader base, or a consumption base, and take the necessary steps to implement such a system. This would mean an explicit choice of a new approach to taxes, comprehensive and carefully thought out; and a difficult period of transition to reconcile the new system with the old while safeguarding the economic interests of those who have made financial decisions based on the present system. The potential pitfalls with this approach are that it requires long-range planning and implementation, and there is the risk that the consensus behind the new system could erode during the lenghty course of implementation, that could leave us with a system no better, or even worse, than present law.

Finally, we might agree to proceed, again on a step-by-step basis, to couple base-broadening measures or steps toward a different tax base with rate reductions in an effort to simplify the system and reduce tax-induced distortions of economic decisionmaking. The advantages here would be that we would have an opportunity to think out each step as it is taken, and to build a consensus on the desirability of those steps. The disadvantage is that you would not make a specific commitment to a bottom-line goal for our tax policy.

MUCH TO BE DONE

Just outlining the policy options and procedural options makes clear how much there is to be done if we want to rebuild our tax system in a way that is fairer, simpler, and better for the economy. No system can be sustained without a strong popular consensus: Indeed, a major reason we are considering fundamental reforms is the indication of weakening consensus behind our present system, as demonstrated by the growing compliance problem. We do not want to hastily adopt a system that cannot be sustained over time, either because of technical flaws or lack of popular support.

So our task is to begin to search out the kind of consensus needed to support any far-reaching change in tax policy. The direction has been set, in a way, by the rate reductions adopted in 1981 and the base-broadening and compliance measures we agreed to in 1982 and again this year. We have already moved toward lower rates and a broader base, and have put the pressure on to reexamine the tax system by indexing individual rates to end bracket creep. There does seem to be a growing consensus for further reduction of rates and broadening of the tax base. With proper balancing of the goals of equity, efficiency, and simplicity, that consensus could grow. I hope the witnesses this morning, and over the course of these hearings, will shed some light on the prospects for dramatic change in taxation as well as help clarify our choices.

OPENING STATEMENT OF SENATOR CHARLES GRASSLEY

Mr. Chairman. I would like to commend you for holding these important hearings on tax reform. As you know, I have a special interest in tax reform, as an end in itself. But, also, whenever I am home in Iowa, I am always asked about tax reform, particularly the flat rate tax. While I am certain many of my constituents are interested in tax reform because they think their rates will decline, many are willing to pay more for a simple, understandable system.

As Chairman of the Subcommittee on the Oversight of the IRS, I feel tax reform is essential if we are to retain our system of voluntary compliance for revenue collection. We are nearing the point where the complexity of the system is threatening tax administration. Our system is so intricate it is difficult for either the auditing revenue officer or the tax practitioner to keep abreast of the law. By enacting three major tax bills in four years, we have swamped the rulings and regulations professionals at the Internal Revenue Service. Unless we stop passing tax bills, no one will be able to figure out how to pay their taxes and the IRS will be unable to figure out how to collect them.

By hitting practitioners with legislation in excess of 1,000 pages, we are undermining their ability to provide their clients with correct advice. If tax experts are unable to ascertain the law, our entire system of voluntary compliance teeters on the edge of collapse.

As my colleagues know, we simply cannot hire enough revenue officers to audit everyone in the United States. We cannot afford to pay full time taxpayer service assistants to answer all of the questions we are generating by our constant legislation. When taxpayers and their advisors cannot unravel the system, it is likely that compliance will suffer.

One part of our compliance effort in 1982 was to collect some of the $50–$60 billion dollars of revenue that goes uncollected every year by taxpayers who overstate deductions and fail to include income items on their returns. In that legislation, Congress required the submission of more information to the IRS and imposed stricter penalties on non-compliant taxpayers. The second part of our compliance responsibility is to devise a system that taxpayers can understand to avoid those penalties.

Many taxpayers feel the current system is unfair since taxpayers in the same income bracket may have dramatically different tax liability depending upon their tax planning. The perception of unfairness erodes compliance. Individuals feel no responsibility to comply with a system they find to be fundamentally unfair.

Unless we take dramatic steps to simplify the current system, all of our compliance efforts will be undone. We are being buried by detail.

In my subcommittee, we have held a series of hearings on whether or not our current code stimulates productivity. To focus this broad inquiry, we have looked at the economy by sectors. First, we examined the impact of the tax code on productivity in agriculture and small business; next, we focused on basic industries, services and financial institutions. We plan to hold a hearing on September 17th summarizing our findings; however, the uniform complaint of all witnesses has been the complexity of the current code and the lack of consistent policy objectives. Economists, small businessmen, and basic industry chief executive officers are all frustrated by our constantly changing system. They want a simplified system they can use as the basis for long range plans. All are concerned about the costs we impose by forcing them to learn a new tax system each year.

These hearings have also shown us our system contains a group of conflicting economic objectives. We have different tax provisions for the stimulation of capital investment, a patchwork of schemes for encouraging manpower training and inconsistent policies regarding interest earned and interest paid. While our society is complex and some of the rules which govern technical transactions might be more difficult, the least we should require is that they are consistent. There is no evidence we judge new tax provisions by that criteria now.

I think tax reform is important for taxpayers, tax compliance, and the economy. I do not feel it should be used as a white-wash to raise additional revenue. On the four years I have been on this committee, I have been convinced that we will never raise taxes quickly enough to catch up with our spending increases. Although I think tax increases are a terrible way of managing our economy, as a practical matter tax increases will simply not close the revenue gap. Spending restraint is essential to accomplish a reduced deficit.

Again, let me stress I do not view tax reform as a way to increase revenue. Tax reform is necessary to restore public confidence in our self-assessment system and to make it administrable.

Mr. Chairman, I look forward to the comments of the witnesses on this topic of great importance.

STATEMENT OF SENATOR MAX BAUCUS, SENATE FINANCE COMMITTEE, AUGUST 7, 1984

INTRODUCTION

Thank you, Mr. Chairman. I want to commend you for calling these hearings. They give us an important opportunity to address an issue that everyone is concerned about these days: taxes.

PUBLIC DISENCHANTMENT

Mr. Chairman, there's growing disenchantment with the tax system. We can see evidence of it all around us:

In the tax revolts in Michigan and elsewhere.

In the $100 billion "underground economy" of unreported cash transactions.

And in the tax protester movement, which is especially strong in the West.

Back in my own state of Montana, a lot of people are plain fed up. Let me read some excerpts from letters I've received from Montanans recently:

One writes that "the laws are too complicated when it requires several pages just to explain how to determine your filing status . . . it definitely is too complicated for the average person."

Another writes that "it is clear that the only beneficiary of such complex tax regulations are accountants and lawyers."

And a third writes that "it sure is disgusting for the low income people to have to continue to pay so much of their wages in taxes while the rich people continue to have ways of avoiding most if not all taxes."

THE PROBLEM

Mr. Chairman, these letters are right on target. We've tried to accomplish so many social and economic objectives with our tax system, that we've lost control of it.

As a result, the system is too complex.

It's unfair.

And it makes our economy less efficient.

Let me explain. We enacted the modern income tax in 1913. For the next fifty years or so, we used it primarily for collecting revenue.

But then we began using the tax system to achieve broad social and economic objectives. Today, the tax code contains over 100 separate tax preferences, covering everything from aircraft exports to windmills.

COMPLEXITY

As a result, the tax code has grown enourmously complex.

It's now longer than the Bible, Talmud, and Koran combined. And the regulations are five times longer.

Given this complexity, many people can't fill out their tax returns: in 1981, over forty percent paid commercial tax preparers to fill their forms out for them.

UNFAIRNESS

What's more, this complexity makes the system unfair.

There's so many exemptions, exclusions, deductions, and credits that, frequently, two people who earn the same income don't pay the same tax.

And wealthy taxpayers, who can hire experts to design elaborate tax shelters, wind up avoiding a large share of the tax that they should be paying.

INEFFICIENCY

On top of all this, the tax system makes our economy less efficient.

Because the system offers so many opportunities to reduce taxes through sophisticated gamesmanship, it discourages savings, distorts the allocation of economic resources, and diverts people out of productive businesses and into the tax business.

Just as great civilizations before us spent their wealth building pyramids and cathedrals, we are spending ours building elaborate tax shelters.

At a time when we're trying to regain our international competitive edge, this is a terrible waste.

THE FRAMEWORK FOR REFORM

Given the mess we're in, we must overhaul the tax code, to make the tax system simple, fair, and efficient.

But how do we accomplish this?

First of all, we must lower the rates. That will increase the incentive to work and reduce the incentive to invest in tax shelters.

But the rates must remain progressive. Otherwise, we will be shifting heavier tax burdens onto middle and lower income taxpayers.

And the rates must remain indexed. Otherwise, "bracket creep" will push middle and lower income taxpayers into higher tax brackets even when their real income doesn't increase.

Second of all, we must eliminate many tax preferences.

This is easier said then done, because there's a fundamental tension underlying our debate about tax preferences.

On one hand, we can accomplish some important social and economic objectives better with a tax incentive than with a spending program or a regulation. For example, if we want to encourage increased savings, it may be more efficient to do so by creating deductable IRA accounts than by any other means.

On the other hand, Congress has been unable to resist what one expert calls "the inclination to riddle the income tax with rewards for almost every conceivable social or economic action deemed somehow desirable."

Some respond to the dilemma by proposing that the tax system should never be used to achieve broad social or economic objectives.

I disagree.

That approach would prevent us from accomplishing important public objectives—like encouraging increased savings and business investment, or encouraging people to contribute to charity.

But there's no reason to throw the baby out with the bath water like that. Instead, we should try to develop clear, discliplined criteria for deciding what stays and what goes.

Let me propose three such criteria.

First, we should use tax preferences only to achieve broad public objectives, not to help narrow special interests. Otherwise, *every* special interest will demand special treatment, just like they do now.

Second, we should use tax preferences only when there's a clear public consensus that we do so. Otherwise, we undermine confidence in the system.

Third, we should use tax preferences only when we can't accomplish our objective any other way. If we *can* accomplish it some other way, we should leave the tax code alone.

By using such criteria, we can eliminate most tax preferences. But, at the same time, we can retain the core ones important to our overall economy.

CONCLUSION

Mr. Chairman, anytime Congress undertakes a major project like overhauling our tax system, we'll probably disagree about just how to do it.

But I hope we'll agree about one point.

We can't wait any longer. We've got to try to restore public confidence in our tax system, before it's too late.

To accomplish this, we must reform the tax system to make it simple, fair, and efficient.

If this means putting partisan differences aside, we must.

And if this means putting special interests aside, we must.

The stakes are so high, we can't afford not to.

Mr. Chairman, when Congress enacted the income tax in 1913, the Ways and Means Committee said that "all good citizens * * * will cheerfully support and sustain it."

Those of us responsible for Federal tax policy must work together, and hammer out a tax reform package, until we can confidently say the same thing.

The **Chairman**. I think while Senator Roth is moving to the table, I might just briefly indicate the purpose of the hearings today and on Thursday. We are not here to get involved in debate between candidates on whether a tax increase is or is not necessary. That is not the purpose of this hearing. We have been talking about these hearings for a number of months. We had hoped to have them in June, but as everybody knows, we became involved in the tax bill, and that took care of that month. And of course, in July we were not here. But it has seemed to me for some time—and I am certain this is the view of many others in the committee—that there are a number of options floating around this town, and outside this town, on simplification, and it occurred to me that we ought to at least try to focus on some of those options.

As you know the Treasury Department has had a series of hearings. They are looking at different simplification proposals and structural changes. So, it is my hope that today and again on Thursday, we can establish a useful record and then do so again in September. I might say there were a number of witnesses who wanted to testify this week—House Members and others who would like to testify, including some additional colleagues in the Senate—so we will have at least 2 additional days of hearings in September to conclude this review.

Obviously, what happens next year in tax policy depends on a number of factors. First of all, who the President may be. Who may control the Congress. Who may be the chairman of this committee. And a number of other factors that we cannot determine. So, hopefully, we can avoid all the political questions—unless somebody wants to discuss those.

We are pleased to have as our first witness our colleague on the committee and the author of the Roth-Kemp bill—it is always Roth first on the Senate side, and if it is ever repealed, we won't repeal that part of it.

But Bill Roth has been in the forefront of tax reduction in an effort to expand the economy and encourage savings, and I think has done an outstanding job.

So, Bill, I can't think of a better way to start off these hearings than with you as the first witness.

Senator ROTH. Thank you, Mr. Chairman. First, let me applaud you for holding these hearings. I believe that for the first time in many years we have a real opportunity to bring about major tax reform. The reason I say that, Mr. Chairman, is that I am encouraged by the fact that Members on both sides of the political aisle are coming forward with creative plans to overhaul our cumbersome tax system.

I would like to congratulate Senator Bradley and Congressman Gephardt as well as my good friend, Jack Kemp, and Senator Kasten for their very imaginative plans. I think it is important that as we approach this reform, we do so in a bipartisan spirit. Now, Mr. Chairman, the various proposals that are currently being debated have several things in common. First, and I think most important, they all reduce marginal tax rates. I think you can recall very well a few years ago when I first began talking about that in this committee. It was very controversial. There was very little understanding of the damaging effect of high marginal rates. Today, there is almost universal agreement that high marginal rates are a deterrent—a deterrent to our economic growth. And I think it is most gratifying to note that all the various proposals from both sides of the aisle today strive to lower these rates.

Second, Mr. Chairman, all the plans greatly broadened the tax base from that of current law by eliminating most credits and deductions. And all the plans greatly simplify the Tax Code. Now, I think that is most important, too, because most importantly, there has been a serious erosion of public confidence in the tax system. And the one way I think to reverse that trend is to make the Tax Code both simple and fair. So, I applaud all these proposals in that sense—that they do seek to regain public confidence by simplicity and fairness. But, Mr. Chairman, there is one additional area that

I think needs to be addressed and needs to be addressed badly in any effort to reform our Tax Code.

And it is for this reason that I developed my own plan. It is crucially important that any tax reform plan adopted by Congress address the need for sustained long-term vibrant economic growth for our Nation. It is not enough—it is not enough in my opinion—merely to secure the necessary revenue in a fair means, but we must do it by such a method, by such a manner as to promote economic growth. Crucial to that end is a healthy rate of personal savings and capital formation. Our major trading partners in the Pacific, especially Japan, all save substantially more than we do.

If we are to become competitive in the world economy, we simply must save more. In the interest of time, Mr. Chairman, I will just point out that the Japanese save 19.2 percent. Our savings has been as low as 4.7. There are many factors that explain this, but it is no coincidence that Japan with its 20-percent savings rate has built substantial savings incentives into its code. It is also no coincidence that our Tax Code as it presently exists has strong antisaving biases, and of course, as a result has discouraged savings. Now, why are savings so important? Every dollar saved is a dollar that can go to new investment, to build new plants, or to modernize old ones, and thereby to create jobs. Savings is the engine that drives long-term economic growth.

Now, my tax plan, like the others, broadens the tax base, reduces marginal rates and simplifies the tax system, but it goes one vital step further. It would remove the existing bias against saving and investment in order to provide our Nation with the needed savings for economic growth. This plan, Mr. Chairman, is the logical next step down the road to long-term economic prosperity that began when Jack Kemp and I began to develop our tax plan in the late 1970's. Our tax cut, along with the other aspects of President Reagan's economic recovery program, has helped create the strongest economic recovery since World War II.

I believe that tax reform which provides incentives for savings will enable us to sustain that recovery for many years in the future. Let me briefly describe my tax plan.

Most existing credits and deductions will be repealed. We will retain a mortgage interest deduction, a deduction for charitable contributions, a deduction for catastrophic medical expenses, additional legitimate business expenses for a personal business will of course be deductible.

In order to ensure that no one below the poverty line will have to pay taxes, generous standard deductions and personal exemptions will be allowed. A family of four will have the first $10,000 of income exempt from taxation. In order to encourage savings, my plan establishes a super saving account, SUSA for short. This is the cornerstone of the legislation. The SUSA would function much like current IRA's, except that savings could be for any purpose, not just retirement. And the funds could be withdrawn at any time without penalty. Net contributions to the SUSA would be tax deductible, and net withdrawals would be added to taxable income. Within the account, investments could be made in any financial asset. The limits on the SUSA would be $10,000 for an individual, $20,000 for a couple filing jointly. Existing IRA's would be rolled into the SUSA's, but my plan would retain existing Keough's as a separate entity not covered by the SUSA limit.

The second major feature of my plan is to replace the complicated system of capital recovery provisions and credits for equipment with immediate expensing. This is crucial to our goal of creating an environment for investment for economic growth. Of course, any proposal as dramatic as this poses a number of transition problems. I have been told by the Joint Committee on Taxation that phasing in my plan over 5 years would mitigate many of these problems. And, Mr. Chairman, I would like to express publicly my thanks to the Joint Committee on Taxation for the splendid work they have done for me. I have also been told that a permanent rate structure—or three rates between 15 and 30 percent—will be sufficient to make the system revenue-neutral. We are developing a common companion piece of legislation to address corporate taxes. It will be designed to lower rates, eliminate most of the special credits and deductions, and replace ACRS with expensing. It will be designed to encourage investment for growth. Mr. Chairman, I believe this committee and the Congress as a whole are approaching a once-in-a-lifetime opportunity to make genuine meaningful changes in our tax system, a system that is outmoded, cumbersome, and unfair to large segments of the American public. As these hearings show, our colleagues from both parties—all points of the political spectrum—are taking up the call for a real tax reform. The time is right to devise a system that is simple, fair, and most important, a system that will encourage savings and investment to lay the groundwork for sustained economic growth and job creation for our Nation, as well as a better life for all our citizens.

Thank you, Mr. Chairman.

[Senator Roth's news release follows:]

U.S. Senator

BILL ROTH

NEWS RELEASE

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HOLD FOR RELEASE:
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ROTH SAYS TAX REFORM SHOULD ENCOURAGE SAVINGS

WASHINGTON -- Senator William V. Roth, Jr., R-Del., said today that a key element of any tax reform plan adopted by Congress should be the elimination of the existing system's "bias" against savings and investment.

Testifying before the Senate Finance Committee, which is holding hearings on a variety of tax reform plans now before Congress, Roth said he is preparing a comprehensive tax plan aimed at encouraging savings and investment while making the tax system both simpler and fairer.

Roth said the centerpiece of his plan is the creation of "Super Savings Accounts," or SUSAs, which will allow taxpayers to save up to $10,000 a year ($20,000 for couples filing jointly) tax-free. Money in the accounts, which could be invested in a variety of ways, would be taxed only when withdrawn and spent.

Roth said his new plan is a "logical next step" to follow the Roth-Kemp tax cut plan adopted by Congress in 1981. The tax cut was a central feature of President Reagan's economic recovery plan, which Roth credited with helping bring about the "strongest economic recovery since World War II.

"I believe that tax reform which provides incentives for saving will enable us to sustain that recovery for many years into the future," Roth told the committee. "Every dollar saved is a dollar that can go to new investment to build new plants or to modernize old ones and to create jobs."

Noting that both Republicans and Democrats from all points on the political spectrum have proposed tax reform plans in recent months, Roth said next year will provide a "once-in-a-lifetime opportunity" for Congress to make "genuine, meaningful changes in our tax system -- a system that is outmoded, cumbersome and unfair to large segments of the American public.

"The time is ripe to devise a tax system that is simple, fair, and -- most important -- a system that will encourage savings and investment, to lay the groundwork for sustained economic growth for our nation and to create jobs and a better life for all of our citizens," Roth said.

Roth said savings incentives are needed because the United States is lagging well behind many of its trading partners -- notably Japan -- in its rate of personal savings. Japan's high savings rate has been a key factor in that nation's ability to catapult ahead of much of the rest of the world in modernizing its industry and capturing international trade and new jobs. While the Japanese saved 19.2 percent of their disposable income in 1983, the United States had a savings rate of only 4.7 percent.

"It is no coincidence," Roth said, "that Japan, with its 20 percent personal savings rate, exempts the first $12,000 of savings from taxation and treats much interest as non-taxable. It is also no coincidence that our tax code, with its anti-savings bias, discourages saving.

"It is crucially important," Roth said, "that any tax reform plan adopted by Congress address the need to sustain long-term, vibrant economic growth for our nation. Crucial to that end is a healthy rate of personal saving and capital formation. If we are to remain competitive, we simply must save more."

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(A fact sheet outlining Roth's tax reform proposal is attached.)

STATEMENT BY
SENATOR WILLIAM V. ROTH, JR.
BEFORE THE SENATE FINANCE COMMITTEE
AUGUST 7, 1984

Mr. Chairman, let me say at the outset that I applaud you for holding these hearings. I think that we are on the verge of a period of great debate in the area of tax reform. I am greatly encouraged that Members on both sides of the aisle have come forward with creative plans to overhaul our cumbersome tax system. Senator Bradley and Congressman Gephardt have introduced an imaginative plan of tax reform, as have Congressman Kemp and Senator Kasten and I wish to state that these four deserve a great deal of credit, as do the others who have come forward. The move towards basic reform of the tax system is truly becoming a bipartisan effort, as it must be if it is to succeed.

The various proposals that are currently being debated have several things in common. First, they all reduce marginal tax rates. When Jack Kemp and I first introduced our tax cut measure several years ago, there was little understanding of the damaging effects of high marginal tax rates. Now, there is almost universal agreement that high marginal tax rates are a deterrent to economic growth and it is gratifying to note that all the tax reform plans now under discussion strive to lower these rates. Second, all the plans greatly broaden the tax base from that of current law. And, all the plans greatly simplify the tax code.

These are laudable goals, and attainment of these goals should be supported by all of us. But there is one additional area that needs to be addressed in any effort to reform our tax system, and it is for this reason that I developed my own plan.

Mr. Chairman, it is crucially important that any tax reform plan adopted by Congress address the need to sustain long-term, vibrant economic growth for our nation. Crucial to that end is a healthy rate of personal saving and capital formation. Our major trading partners in the Pacific Basin and Western Europe all save substantially more than we do. If we are to remain competitive in the world economy, we simply must save more.

In 1983, Mr. Chairman, the Japanese saved 19.2 percent of their disposable income. The United States, on the other hand, had a savings rate of only 4.7 percent. Over the period from 1970 to present, the U.S. savings rate has averaged less than 7 percent, while the Japanese had an average savings rate of almost 20 percent.

There are many factors that explain a country's saving rate, including cultural factors. But it is no coincidence that Japan, with its 20 percent savings rate, has substantial saving incentives in its tax code. It is also no coincidence that our tax code, with its anti-savings bias, discourages saving.

Why are savings so important? Every dollar saved is a dollar that can go to new investment to build new plants or to modernize old ones and to create jobs. Saving is the engine that drives long-term economic growth.

My tax plan, like the others that have been proposed, will broaden the tax base, reduce marginal rates, and simplify the tax system. But it will go one vital step further. It will remove the existing bias against saving and investment, in order to provide our nation with the needed savings for economic growth. This plan, Mr. Chairman, is the logical next step down the road to long-term economic prosperity that began when Jack Kemp and I developed our tax cut plan back in the late 1970s. Our tax cut, along with the other aspects of President Reagan's economic recovery program, have helped create the strongest economic recovery since World War II. I believe that tax reform which provides incentives for saving will enable us to sustain that recovery for many years into the future.

Let me briefly describe my tax plan, which will replace the existing individual income tax. Most existing credits and deductions will be repealed. We will retain a mortgage interest deduction, a deduction for charitable contributions, and a deduction for catastrophic medical expenses. In addition, legitimate business expenses for a personal business will, of course, be deductible.

In order to insure that no one below the poverty line will have to pay taxes, generous standard deductions and personal exemptions will be allowed. A family of four will have the first $10,000 of income exempt from tax.

In order to encourage saving, my plan establishes a Super Savings Account or "SUSA" for short. This is the cornerstone of the legislation. The SUSA would function much like current IRA's, except that saving could be for any purpose, not just retirement, and the funds could be withdrawn at any time without penalty. Net contributions to the SUSA would be tax deductible and net withdrawals would be added to taxable income. Within the account, investments could be made in any financial asset. The limits on the SUSA would be $10,000 for an individual and $20,000 for a couple filing jointly. Existing IRA's would be rolled into the SUSA's, but my plan would retain existing KEOGHS as a separate entity not covered by the SUSA limits.

The second major feature of my plan is to replace the complicated system of capital recovery provisions and credits for equipment with immediate expensing. This is crucial to our goal of creating an environment for investment for economic growth. Lives for structures will also be shortened.

Of course any proposal as dramatic as this poses a number of transition problems. I have been told by the Joint Committee on Taxation that phasing in my plan over five years will mitigate many of these problems. I have also been told that a permanent rate structure of three rates between 15 and 30 percent will be sufficient to make the system revenue neutral. In addition, the rates will be structured so that the income distribution of current law can be approximated.

I am now developing a companion piece of legislation to address corporate taxes. It will be designed to lower rates, eliminate most of the special credits and deductions, and replace ACRS with expensing. It will be designed to encourage investment for growth.

Mr. Chairman, I believe this Committee and the Congress as a whole are approaching a once-in-a-lifetime opportunity to make genuine, meaningful changes in our tax system -- a system that is outmoded, cumbersome and unfair to large segments of the American public. As these hearings show, our colleagues from both parties and all points on the political spectrum are taking up the call for real tax reform. The time is ripe to devise a tax system that is simple, fair and -- most important -- a system that will encourage savings and investment, to lay the groundwork for sustained economic growth and job creation for our nation and a better life for all of our citizens.

FACT SHEET ON THE ROTH "SUPER SAVINGS ACCOUNTS" TAX REFORM PLAN

Goal

To insure the nation's long-term economic growth and health by providing incentives for savings and investment -- the chief source of capital for industrial growth and modernization.

Guiding Principles

Basic reform of the tax system must address these areas:

Neutrality

Economic decisions should be based on economic criteria, not on tax rules. Tax reform should remove existing biases in the tax code, the most prominent of which is an inherent bias against saving and investment.

Equity

The tax system should be as fair as possible.

Simplicity

One of the most important goals should be to relieve the administrative burden of the present system.

Revenue

The new system should be structured, in its initial form, to raise the same amount of revenue as the existing system.

The Proposal

Senator Roth is proposing that Congress replace the present personal income tax with a broad-based system that contains generalized savings incentives to remove existing anti-savings biases and that employes low, relatively flat marginal rates. In broad outline, the system would look like this:

The Filing Unit

The filing unit is the family. In order to add progressivity to the system and to insure that no one below the poverty level pays taxes, the system will include a generous zero bracket amount and personal exemptions. The system allows a zero bracket amount of $3,000 for taxpayers filing singly and $6,000 for couples filing jointly, plus a $1,000 personal exemption for each family member. Thus a family of four would have its first $10,000 of income exempt from taxation.

The Tax Base

The tax base would be substantially broadened by eliminating most credits and exemptions and only a few deductions would be allowed. These would be the zero bracket amounts and personal exemptions listed above, a mortgage interest deduction, a deduction for charitable contributions, business deductions associated with a personal business, a deduction for medical expenses above 10 percent of adjusted gross income, and most important, a deduction for net additions to a generalized saving vehicle, known as a Super Savings Account.

Super Savings Accounts

The Super Savings Account ("SUSA") is similar to existing Individual Retirement Accounts. The savings in the SUSA, however, can be used for any purpose -- not just retirement. As such, funds can be withdrawn from SUSA at any time with no interest penalty.

Super Savings Accounts (Cont.)

The taxpayer will receive a deduction for any net deposits to the SUSA. Net withdrawals will be added into the tax base. There will be limits on the Account: A taxpayer filing singly will be allowed to contribute up to $10,000, tax free, to a Super Savings Account each year. For those filing jointly, the limit will be $20,000.

These limits imply that for the average middle-class taxpayer, all saving will be tax deferred. The very rich, however, will not be able to escape the tax completely while accumulating large amounts of capital.

Saving in a SUSA can take any financial form: stocks, bonds, passbook savings, money market certificates, etc. As with Individual Retirement Accounts, a taxpayer will have the option of directing his or her investments or having the financial intermediary direct them.

Private Fringe Benefits

Private consumption fringes provided by employers would be part of the tax base.

Indexing

The system will be indexed against inflation.

The Rate Structure

A system of three rates in the 15-to-30 percent range, would make the system revenue neutral relative to present law and would lead to an approximation of the income distribution under present law.

The Corporate Side

A companion proposal concerning corporate taxes will be developed.

# # # #

The CHAIRMAN. Senator Long, do you have any questions?

Senator LONG. I came in the middle of your statement, Senator. I wouldn't do justice to it if I asked questions at this point. Thank you very much for your statement. I will read it all.

Senator ROTH. Thank you, Senator Long.

Senator PACKWOOD. Bill, I have just one question. You cite the figure on the savings rate in Japan and here. All during the 1950's and the 1960's, our average savings was around 7 or 7.5 percent. It reached a high of 8.2 percent in 1972, then went down a little. But how did we sustain those tremendous rates of growth in the 1950's and 1960's with still a relatively low savings rate in comparison to other countries?

Senator ROTH. I would say to you, Bob, that this is a very different world from that of the 1950's. No. 1, we were the industrial leader—the industrial giant. The other countries were just beginning to develop their industrial systems, so there was not the competition that there is today. These other countries were just moving into the industrial age because of the problems of World War II.

So, that is point No. 1. We were the giant in those days, so we did not have the competition. But point No. 2 is that we are in a new world economy. What we produce will only sell if it is competitive with what is produced abroad, and the fact is that in many areas, the Japanese as well as other countries around the rim of Asia have outpaced us, have outlead us. Let me point out to you in two regards. First of all, our so-called smokestack industries have fallen behind, because we haven't had the savings to modernize them. But in many ways as important if not more important is that in this new technological revolution, change is the constant. And the country that has the capital savings to incorporate the latest technologies are the ones that are going to lead in the new industrial world. So, I don't think the 1950's are relevant to the world of today any more than the 1930's.

And as I say, the key component in keeping on the cutting edge of this world competition is these savings and capital formation to ensure that our plants incorporate the latest technology.

Senator PACKWOOD. Thank you.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Mr. Chairman, I have a statement. I have no questions.

The CHAIRMAN. OK. Let's come back to that then. Senator Danforth?

Senator DANFORTH. I have a statement also, Mr. Chairman.

Senator BRADLEY. Mr. Chairman, I have a statement also, but no questions for Senator Roth.

The CHAIRMAN. Thank you very much, Senator Roth. We appreciate very much your being here, and I hope you can join us now.

Let us hear from Senator Kasten, and then we will come back to members' statements, and then we will go into the public witnesses.

We are pleased to have Senator Kasten who also has been in the forefront of the movement toward tax simplification, lowering the marginal rates, tax reduction generally, and he is now cosponsoring a bill with Congressman Kemp. As I have indicated earlier, Bob, we are going to have 2 more days of hearings in September because so many House Members wanted to testify, and 30 or 40 other private sector witnesses so we couldn't do it all in 2 days.

So, we will be glad to hear you today. Maybe we can hear Jack in September.

STATEMENT OF HON. BOB KASTEN, U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator KASTEN. Mr. Chairman, thank you. I welcome the opportunity to testify here today so that I might outline a modified flat tax plan and show you that the benefits of the flat tax are many and show you specifically what those benefits are. Mr. Chairman, I ask unanimous consent that my entire statement appear in the record as if read, and I am going to make an effort to summarize it.

As the hearing this morning indicates, tax reform is the major issue in Washington, and it is a major issue all across the country. Every day we in the Senate and the House of Representatives receive letters and postcards from constituents who are irritated, who are fed up, who are dissatisfied and just plain mad at our present tax system.

The bottom line is always the same. The American taxpayers deserve a tax system that is fair, simple, and yet provides incentives for savings, for investment, for risk taking, and for economic growth. It is time for an overhaul of our current system and the fair and simple tax plan will do it. The fair and simple tax plan offers the best features of a flat tax—a single tax rate applied to an expanded tax base, along with special provisions for the working poor, for families with children, homeowners, savers, and small businesses.

The CHAIRMAN. Could I just ask a question? I guess the name for yours is FAST, is that correct?

Senator KASTEN. Fair and simple tax—that is FAST.

The CHAIRMAN. So, we have FAST and FAIR, FLAT, and——

Senator KASTEN. The FAST tax is the best of the modified flat taxes that are available, Mr. Chairman.

The CHAIRMAN. We are please to know that. That will make our work easier. [Laughter.]

Senator KASTEN. I might say, just parenthetically, that the work that Senator Bradley and Congressman Gephardt are doing in my view is positive, and I hope that they view the work that Jack and I are doing as being positive. We are all trying to go in the same direction. The fact is we have got some differences, but I would rather—and we will explore those differences—but I would rather look at the positive aspects of both of us at least trying to go in the same direction, which is I think where the American people want to go.

The CHAIRMAN. I might just say they were doing a little work in Minnesota yesterday. I am not certain how that worked out. At least they got back.

Senator BRADLEY. Very interesting, Mr. Chairman. Very interesting, and very positive.

The CHAIRMAN. Very positive. [Laughter.]

Senator KASTEN. Mr. Chairman, it is important to recognize that ours is not a tax increase.

The **Chairman**. Right. We are opposed to those, aren't we? [Laughter.]

Senator **Bradley**. Is that for the record, Mr. Chairman?

The **Chairman**. Whatever record there is of it.

Senator **Kasten**. In brief, the plan caps the tax rate at 25 percent, doubles the personal exemptions, provides an employment income tax credit, and maintains many of the essential deductions in current law. Many people are concerned that a pure flat tax would eliminate some deductions that most middle income Americans consider absolutely essential. In our proposal, we maintain the current tax law treatment of mortgage and other interest payment deductions, of charitable contributions, of property taxes, ordinary business expenses, pensions, IRA's and social security. Many critics have voiced concern that a flat tax would raise taxes on lower income earners. I am also quite concerned about this aspect of a pure flat tax. So, FAST is designed to keep the tax burden facing the low and middle income payer the same, if not lower, than in current law.

Now, this is done first of all by doubling the personal exemptions from $1,000 to $2,000, raising the standard deduction or zero bracket amount, and offering the employment income credit. As a result, the FAST tax ends up by taking 1.4 million taxpayers off the tax rolls, and that 1.4 million are people from the bottom, not the top. While Americans in the upper income brackets will have their income tax reduced from 50 to 25 percent, many of the tax loopholes that they now use to shelter income will no longer be available.

The American taxpayers are tired of a tax system that robs Peter to pay Paul, that grants loopholes for some but not for everyone. With our current tax system, and depending on the source of income and opportunity to take advantage of tax preferences, taxpayers with the same amount of income can pay very different rates in amounts of tax. This I believe is the key complaint coming from our constituents.

Our plan—this plan—will be a welcome alternative to the current confusion and to the widespread inequality of the current Tax Code. The FAST plan provides a single, low rate on income and it is simple enough to figure without even using a tax table. It broadens the tax base by eliminating most loopholes, and a preliminary estimate from the Joint Committee on Taxation shows that FAST will raise about the same amount of revenue as current law. One of the things that we were attempting to do, Mr. Chairman, is not increase or lower taxes in the process of coming up with this sytem. Essentially, this is revenue-neutral totally and revenue-neutral by most brackets in terms of income.

Importantly, FAST is not biased against the family. In fact, it is very profamily. It doubles the personal exemption from $1,000 to $2,000, as I mentioned. It increases the standard deduction to $2,700 for a single person or head of household. And $3,500 for a couple filing a joint return. Both are indexed to inflation. The result of these deductions and exemptions is that a working family of four would pay no tax on the first $14,375 of income. FAST is fair. Under this plan, no one below the poverty level will pay taxes. This isn't so with the current tax law. In fact, right now a family of four pays taxes on income over $8,936, while the official poverty level for them is $11,100. The FAST plan raises the threshold above the poverty level so that a family of four will not pay tax until it is well over the poverty level. Essentially, what we are doing here is trying to get at the problem of marginal initial-entry jobs. FAST helps millions of Americans get out of the poverty track. Because of the high marginal tax rates, Americans receiving welfare benefits now sometimes hesitate to take that initial-entry job for roughly the same amount of money that they are getting in Government benefits.

The tax on the earned income leaves them with less money—less disposable income—than they got through welfare or other kinds of Government assistance programs. Since FAST raises the income tax threshold above the poverty level, the choice between working and receiving welfare or Government assistance is avoided. We are going to get people on to the ladder toward opportunity. Two years ago, it cost Americans over $60 billion just to have their tax forms filled out. And those were the people who could afford to hire others to do the work. It takes 650 million man-hours to work on tax forms required by the Federal Government. Our present Tax Code has more than 5,100 pages, and in addition, there are about 10,000 pages of IRS interpretations of those 5,100 pages, and Congress is about to pass a new tax bill that once more runs over 1,000 pages. Finally, taxes in this country has become a nightmare for most Americans. FAST is designed to bring efficiency and fairness into the Tax Code, and I thank you for the opportunity to discuss this program with you today.

[Senator Kasten's prepared written statement follows:]

STATEMENT OF SENATOR BOB KASTEN ON THE FAIR AND SIMPLE TAX
S. 2600/H.R. 5533
SENATE FINANCE COMMITTEE
AUGUST 7, 1984

MR. CHAIRMAN, I AM PLEASED TO APPEAR HERE THIS MORNING TO DISCUSS TAX REFORM. MY GOOD FRIEND CONGRESSMAN JACK KEMP AND I HAVE SPONSORED THE FAIR AND SIMPLE TAX PLAN (FAST), WHICH WE BELIEVE WILL PROVIDE THE AMERICAN TAXPAYERS WITH MUCH NEEDED RELIEF FROM THE CURRENT TAX SYSTEM.

MR. CHAIRMAN, YOU ARE TO BE COMMENDED FOR HOLDING THIS HEARING, AND FOR GIVING EVERYONE A CHANCE TO DISCUSS TAX REFORM. AS YOU KNOW, THIS HEARING IS ESPECIALLY IMPORTANT SINCE SECRETARY REGAN IS WORKING ON A PLAN TO MAKE OUR TAX SYSTEM FAIRER, SIMPLER, AND LESS OF A BURDEN ON OUR NATION'S ECONOMY AND TAXPAYERS. I WELCOME THE CHANCE TO TESTIFY HERE TODAY, SO THAT I MAY OUTLINE A MODIFIED FLAT TAX PLAN, AND SHOW YOU THAT THE BENEFITS OF A FLAT TAX ARE MANY, AND THE PROBLEMS ARE SURMOUNTABLE.

AS THIS HEARING THIS MORNING INDICATES, TAX REFORM IS A MAJOR ISSUE IN WASHINGTON -- AND ALL ACROSS THE COUNTRY. EVERYDAY, WE IN THE SENATE AND THE HOUSE OF REPRESENTATIVES RECEIVE LETTERS AND POSTCARDS FROM CONSTITUENTS WHO ARE IRRITATED, FED-UP, DISSATISFIED, AND JUST PLAIN MAD AT OUR TAX SYSTEM. THE BOTTOM LINE

IS ALWAYS THE SAME -- THE AMERICAN TAXPAYERS DESERVE A TAX SYSTEM THAT IS FAIR, SIMPLE, AND YET PROVIDES INCENTIVES FOR SAVINGS, INVESTMENT, RISK-TAKING, AND ECONOMIC GROWTH. IT'S TIME FOR AN OVERHAUL OF OUR CURRENT TAX SYSTEM, AND THE FAIR AND SIMPLE TAX PLAN WILL DO IT.

THE FAIR AND SIMPLE TAX PLAN OFFERS THE BEST FEATURES OF A FLAT TAX -- A SINGLE TAX RATE APPLIED TO AN EXPANDED TAX BASE -- WITH SPECIAL PROVISIONS FOR THE WORKING POOR, FAMILIES WITH CHILDREN, HOMEOWNERS, SAVERS, AND SMALL BUSINESSES. IN BRIEF, THE PLAN CAPS THE TAX RATE AT 25 PERCENT, DOUBLES THE PERSONAL EXEMPTIONS, PROVIDES AN EMPLOYMENT INCOME CREDIT, AND MAINTAINS MANY ESSENTIAL DEDUCTIONS IN CURRENT TAX LAW.

MR. CHAIRMAN, I KNOW THAT MANY PEOPLE ARE CONCERNED THAT A PURE FLAT TAX PLAN WOULD ELIMINATE SOME DEDUCTIONS THAT MOST MIDDLE INCOME AMERICANS CONSIDER ABSOLUTELY ESSENTIAL. AND SO, IN OUR PROPOSAL WE MAINTAIN THE CURRENT TAX LAW TREATMENT OF MORTGAGE AND OTHER INTEREST PAYMENT DEDUCTIONS, CHARITABLE CONTRIBUTIONS, PROPERTY TAXES, ORDINARY BUSINESS EXPENSES, PENSIONS, IRAS AND SOCIAL SECURITY.

IN KEEPING THE CURRENT LAW TREATMENT OF SOCIAL SECURITY -- BOTH THE TAX AND BENEFIT STRUCTURE -- WE WERE CONCERNED ABOUT THE REGRESSIVE NATURE OF THE SOCIAL SECURITY TAX. IN FACT, MANY LOWER INCOME TAXPAYERS PAY

MORE IN SOCIAL SECURITY (FICA) TAXES, THAN THEY DO IN FEDERAL INCOME TAXES. TO MAKE SURE THAT LOW AND MIDDLE INCOME TAXPAYERS DO NOT FACE A TAX INCREASE AS A RESULT OF THE INTERACTION BETWEEN THE 25 PERCENT TAX RATE AND THE SOCIAL SECURITY MARGINAL TAX RATES, WE PROVIDE AN EMPLOYMENT INCOME CREDIT. TAXPAYERS EARNING LESS THAN $40,000 MAY EXEMPT 20 PERCENT OF THEIR EARNED INCOME FROM TAXATION. THIS EMPLOYMENT INCOME CREDIT -- MUCH LIKE AN EXPANDED EARNED INCOME CREDIT -- COUPLED WITH THE HIGHER PERSONAL EXEMPTIONS, WORK TO ACTUALLY LOWER TAXES IN MANY CASES. THE CREDIT IS PHASED OUT SO THAT THOSE EARNING MORE THAN $100,000 WILL NOT RECEIVE IT.

MANY CRITICS HAVE VOICED CONCERN THAT A FLAT TAX WOULD RAISE TAXES ON THE LOWER INCOME EARNERS. I AM ALSO QUITE CONCERNED ABOUT THIS ASPECT OF A FLAT TAX. SO F.A.S.T. IS DESIGNED TO KEEP THE TAX BURDEN FACING THE LOW AND MIDDLE INCOME TAXPAYER THE SAME, IF NOT LOWER, THAN IN CURRENT LAW. THIS IS DONE BY DOUBLING THE PERSONAL EXEMPTIONS, RAISING THE STANDARD DEDUCTION OR ZERO BRACKET AMOUNT, AND OFFERING THE EMPLOYMENT INCOME CREDIT. AS A RESULT OF THIS, F.A.S.T. ENDS UP TAKING 1.4 MILLION TAXPAYERS OFF THE TAX ROLLS -- FROM THE BOTTOM.

AND WHILE AMERICANS IN THE UPPER INCOME BRACKETS WILL HAVE THEIR INCOME TAX RATE REDUCED FROM 50 TO 25 PERCENT, MANY OF THE TAX LOOPHOLES THEY NOW USE TO SHELTER INCOME WILL NO LONGER BE AVAILABLE. PAYING A LOWER TAX RATE OF 25 PERCENT WILL BE MORE AGREEABLE TO UPPER INCOME AMERICANS, AND I BELIEVE THAT OVER TIME THE FEDERAL GOVERNMENT WILL GET MORE TAX REVENUE WITH THIS PLAN.

THIS WOULD BE VERY MUCH LIKE THE REVENUE EFFECT WE ARE NOW SEEING AS A RESULT OF THE REDUCTION IN THE TOP TAX RATE FROM 70 TO 50 PERCENT. PRELIMINARY TREASURY DATA SHOWS THAT TAXPAYERS IN THE UPPER INCOME BRACKETS ARE ACTUALLY PROVIDING MORE REVENUE TO THE TREASURY.

THE FAIR AND SIMPLE TAX WOULD PROVIDE A DRAMATIC CHANGE FROM THE CURRENT TAX SYSTEM. OVER THE YEARS, INFLATION AND THE PROGRESSIVE TAX CODE HAVE PRODUCED A CLIMATE IN THIS COUNTRY THAT ENCOURAGES AMERICANS TO CONSUME RATHER THAN SAVE AND INVEST. THIS CONSUMPTION COMES AT THE EXPENSE OF ECONOMIC GROWTH AND PRODUCTIVITY. THEORETICALLY, OUR PROGRESSIVE TAX SYSTEM RAISES GOVERNMENT REVENUE FAIRLY. IN REALITY, THE STEEP AND GRADUATED TAX SCHEDULE PROVIDES AN INCENTIVE TO AVOID ACTIVITIES THAT ARE SUBJECT TO HIGH TAXES -- ACTIVITIES SUCH AS WORK, SAVING, INVESTMENT, AND RISK-TAKING.

AS THE ECONOMIC CLIMATE SUFFERS FROM RISING MARGINAL TAX RATES -- THE RESULT OF INFLATION AND THE PROGRESSIVE

TAX CODE -- MORE AND MORE TAXPAYERS AVOID TAXES THROUGH LEGAL LOOPHOLES AND EVADE TAXES BY PARTICIPATING IN THE UNDERGROUND ECONOMY. AS CONGRESS PASSES LAWS WHICH, IN ONE WAY OR ANOTHER, EXCLUDE LARGE AMOUNTS OF INCOME FROM THE TAX BASE, HIGHER TAX RATES MUST BE APPLIED TO THE REMAINING INCOME JUST TO BREAK EVEN. AND, AS THE TAX RATES RISE, SO DOES THE INCENTIVE TO AVOID PAYING TAXES -- BOTH LEGALLY AND ILLEGALLY. IN FACT, SOME ECONOMISTS AND TAX EXPERTS BELIEVE THAT THIS AVOIDANCE HAS ACTUALLY LED TO A SYSTEM THAT IS LESS PROGRESSIVE IN REALITY THAN ON PAPER.

THE AMERICAN TAXPAYERS ARE TIRED OF A TAX SYSTEM THAT ROBS PETER TO PAY PAUL -- THAT GRANTS LOOPHOLES FOR SOME, BUT NOT FOR EVERYONE. WITH OUR CURRENT TAX SYSTEM -- AND DEPENDING ON THE SOURCE OF INCOME AND OPPORTUNITY TO TAKE ADVANTAGE OF TAX PREFERENCES -- TAXPAYERS WITH THE SAME AMOUNT OF INCOME CAN PAY VERY DIFFERENT RATES AND AMOUNTS OF TAX.

THAT IS WHY CONGRESSMAN KEMP AND I HAVE PUT TOGETHER THE FAIR AND SIMPLE TAX PLAN. WE BELIEVE THAT OUR PLAN WILL BE A WELCOME ALTERNATIVE TO THE CURRENT CONFUSION AND WIDESPREAD INEQUALITY IN THE CURRENT TAX CODE. THE F.A.S.T. PLAN PROVIDES A SINGLE LOW RATE ON INCOME, AND IS SIMPLE ENOUGH TO FIGURE WITHOUT A TAX TABLE. IT BROADENS THE TAX

BASE BY ELIMINATING MOST TAX LOOPHOLES. AND, A PRELIMINARY ESTIMATE FROM THE JOINT COMMITTEE ON TAXATION SHOWS THAT F.A.S.T. WILL RAISE ABOUT THE SAME AMOUNT OF REVENUE AS CURRENT LAW.

AND, AS A MODIFIED FLAT TAX, F.A.S.T. SOLVES MANY OF THE PROBLEMS OF A PROGRESSIVE TAX SYSTEM. PROBLEMS SUCH AS: THE MARRIAGE PENALTY FOR A FAMILY WITH TWO INCOME EARNERS, THE DISINCENTIVES OF INCREASING MARGINAL TAX RATES AS EARNINGS INCREASE, AND BRACKET CREEP. MANY OTHER LEADING TAX PROPOSALS DO NOT.

F.A.S.T. IS NOT BIASED AGAINST THE FAMILY. IT DOUBLES THE PERSONAL EXEMPTION FROM $1,000 TO $2,000, AND INCREASES THE STANDARD DEDUCTION TO $2,700 FOR A SINGLE PERSON OR HEAD OF HOUSEHOLD AND TO $3,500 FOR A COUPLE FILING A JOINT RETURN. BOTH ARE INDEXED TO INFLATION. THE RESULT OF THESE DEDUCTIONS AND EXEMPTIONS IS THAT A WORKING FAMILY OF 4 WOULD PAY NO TAX ON THE FIRST $14,375 OF INCOME.

F.A.S.T. IS FAIR. UNDER THIS PLAN, NO ONE BELOW THE POVERTY LEVEL WILL PAY TAXES. THIS ISN'T SO WITH THE CURRENT TAX LAW. IN FACT, A FAMILY OF 4 PAYS TAXES ON INCOME OVER $8,936, WHILE THE OFFICIAL POVERTY LEVEL FOR THEM IS $11,100. THE F.A.S.T. PLAN RAISES THE TAX THRESHOLD ABOVE THE POVERTY LEVEL SO THAT A FAMILY OF 4

WILL NOT PAY TAX UNTIL IT IS WELL OVER THE POVERTY LEVEL. THE THRESHOLD IS ALSO LIFTED FOR SINGLE TAXPAYERS AND HEADS OF HOUSEHOLDS.

F.A.S.T. HELPS MILLIONS OF AMERICANS GET OUT OF THE POVERTY TRAP. BECAUSE OF THE HIGH MARGINAL TAX RATES, AMERICANS RECEIVING WELFARE PAYMENTS NOW HESITATE TO TAKE A JOB FOR THE SAME MONEY. THE TAX ON THE EARNED INCOME LEAVES THEM WITH LESS MONEY THAN THEY GOT THROUGH WELFARE. SINCE F.A.S.T. RAISES THE INCOME TAX THRESHOLD ABOVE THE POVERTY LEVEL, THE CHOICE BETWEEN WORKING AND RECEIVING WELFARE IS AVOIDED.

EXACTLY WHAT DOES THIS MEAN FOR INDIVIDUALS? THE FOLLOWING EXAMPLES SHOW TYPICAL AMERICAN TAXPAYERS, THE TAXES THEY PAY NOW, AND THOSE TO BE PAID UNDER F.A.S.T.

	1984 LAW	FAST	TAX REDUCTION
TRADITONAL FAMILY OF 4, $12,000 INCOME	$560	0	$ 560
TRADITIONAL FAMILY OF 4, $30,000 INCOME, AND OWNS HOME	2,695	2,275	420
FAMILY OF 4, WITH 2 INCOME EARNERS, $60,000 COMBINED INCOME, AND OWNS HOME	7,225	6,532	693

AS THE EXAMPLES SHOW, F.A.S.T. PROVIDES TAX RELIEF TO MOST FAMILIES. AND, EVEN THOUGH F.A.S.T. DOES NOT RETAIN THE TWO-INCOME EARNER DEDUCTION AND THE CHILD-CARE CREDIT, A FAMILY OF FOUR WHERE BOTH PARENTS WORK WILL PAY LESS IN TAXES THAN THEY DO NOW.

THE TRADITIONAL FAMILY ALSO GETS TAX RELIEF BECAUSE I DO NOT BELIEVE THE TAX CODE SHOULD DISCRIMINATE AGAINST THE NON-WORKING SPOUSE WHO STAYS AT HOME. THE EXAMPLES ALSO SHOW A FAMILY OF 4 THAT IS JUST OVER THE POVERTY LEVEL OF $11,100 WILL NOT PAY ANY TAX. CURRENTLY THEY DO.

ON THE CORPORATE SIDE, F.A.S.T. ALSO PROVIDES INCENTIVES FOR WORK, SAVING, INVESTMENT, AND BUSINESS ENTERPRISE. THE TREATMENT OF CAPITAL GAINS IS GENEROUS. THE TOP CORPORATE TAX RATE IS CUT FROM 46 TO 30 PERCENT. AND THE CURRENT ACCELERATED DEPRECIATION SCHEDULES, ENACTED IN 1981, ARE RETAINED. WITH F.A.S.T., THE EMPHASIS IS ON REWARDING PROFIT BY TAXING IT AT THE LOWEST POSSIBLE MARGINAL TAX RATE. THE BASE IS ALSO BROADENED BY ELIMINATING MANY CORPORATE TAX AVOIDANCE SCHEMES.

F.A.S.T. RECOGNIZES THAT MANY MILLIONS OF JOBS ARE CREATED IN THE SMALL BUSINESS SECTOR, AND HAS BUILT IN INCENTIVES FOR THEM. THE CORPORATE TAX RATE IS 15 PERCENT ON TAXABLE INCOME UP TO $50,000. AND, F.A.S.T. ALLOWS EXPENSING FOR UP TO $10,000 OF BUSINESS PROPERTY.

ON THE WHOLE, F.A.S.T. IS DESIGNED TO PROVIDE A MORE NEUTRAL TAX SYSTEM WHICH DOESN'T TARGET ANY PARTICULAR INDUSTRY, AND MINIMIZES TAX INTERFERENCE IN THE FREE MARKET.

F.A.S.T. IS A COMPREHENSIVE TAX REFORM PACKAGE THAT WILL PROVIDE AMERICAN TAXPAYERS THE MUCH NEEDED TAX RELIEF THEY DEMAND -- AND DESERVE.

TWO YEARS AGO IT COST AMERICANS OVER $60 BILLION JUST TO HAVE THEIR TAX FORMS FILLED OUT. AND THOSE WERE THE PEOPLE WHO COULD AFFORD TO HIRE OTHERS TO FILL OUT THE FORMS FOR THEM. IT TAKES 650 MILLION MAN-HOURS TO WORK ON THE TAX FORMS REQUIRED BY THE FEDERAL GOVERNMENT.

OUR PRESENT TAX CODE HAS MORE THAN 5,100 PAGES; THERE ARE ABOUT 10,000 PAGES OF I.R.S. INTERPRETATIONS OF THAT CODE, AND CONGRESS IS ABOUT TO PASS A NEW TAX BILL THAT RUNS OVER 1,000 PAGES. FILING TAXES IN THIS COUNTRY HAS BECOME A NIGHTMARE FOR MOST AMERICANS.

F.A.S.T. IS DESIGNED TO BRING EFFICIENCY AND FAIRNESS INTO THE TAX CODE. I THANK YOU FOR THE OPPORTUNITY TO DISCUSS IT WITH YOU TODAY.

The CHAIRMAN. Senator Kasten, we appreciate very much your testimony, and again, I think it is a valuable contribution. As we look at all the different options, let me see if anyone has questions. Senator Packwood?

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Roth?

Senator ROTH. No.

The CHAIRMAN. Senator Long?

Senator LONG. No.

The CHAIRMAN. Senator Bradley?

Senator BRADLEY. No.

The CHAIRMAN. Do you have any questions of Senator Kasten? Senator Grassley?

Senator GRASSLEY. Senator Kasten, if your tax system is adopted, what are we going to do with the 330,000 lawyers and accountants presently who have to interpret this big Tax Code we have now? Where are you going to find jobs for them?

Senator KASTEN. Seriously, I think there will be plenty of work for that group of people, and I see an awful lot of them lined up in the hall that weren't able to get in here today. But I think we are going to be seeing people with an opportunity to get at their tax forms a little bit themselves to do their own work. But I think there is going to be plenty of work for the lawyers.

Senator GRASSLEY. Is part of the theory of your legislation that people will be spending money and making investments based upon the economic determinations of that, as opposed to the tax determinations?

Senator KASTEN. I think there are a number of underlying assumptions. No. 1 is that with the current Tax Code, we are seeing people who are either cheating or who are avoiding through tax avoidance devices that are legal paying the tax that they ought to be paying. If we lower the rate and have a flat tax, we are going to see more and more people paying their taxes, and you can argue—and the Treasury has—that the revenue will go up. In testimony before the House Ways and Means Committee, the Treasury has said they estimate there is something close to $100 billion of nonreported or sheltered income, that if we could have a system that was fair and understandable and people agreed with, that we would be able to see those dollars—those revenue dollars—coming in. The argument is not unlike—it is not exactly like—but not unlike the argument that a number of people made when we reduced the tax rate from 70 to 50 percent on unearned income. Total tax dollars—tax revenues to the Treasury—went up. More people were participating. It is not unlike what Bill Steiger did when we reduced the tax on capital gains. More people—the revenue on capital gains went up, but the other element of this is that if we had a tax system that was simple and easy to understand, we would have more self-compliance. Someone talked the other day about—you know, it could be the middle of the night, and we are driving home at 2 in the morning, and the light changes from green to yellow to red—you stop. You can be out in the middle of a country road. There is no car around—there is no one there. You stop for a minute and a half, you wait, the light goes to green, and you go on.

Our tax system is based just like that traffic system example on self-compliance, on belief in the system.

And what is happening today is that people don't believe that the system is fair or equitable, and essentially we have people running the red lights day after day after day with our Tax Code. If we make it fair and simple, people will have an understanding of the system. They will know it is fair and simple. Everyone is being treated the same. And we are going to see people with a greater degree of self-compliance and agreement. It will leave some of the tax accountants and lawyers behind, but I think there is plenty of work for them to be doing.

The CHAIRMAN. Senator Long?

Senator LONG. Let me just ask one question. Are you proposing treating capital gains as ordinary income?

Senator KASTEN. The capital gains treatment in our plan is exactly as current law.

Senator LONG. So you would leave capital gains just the way it is.

Senator KASTEN. And IRA's and investment accounts.

Senator LONG. Now, capital gains is one of the big items in the complexity of the code now, and a great deal of language that we have in the code is that which tries to draw the line between capital gains and ordinary income.

Your plan would still leave capital gains as it is, I take it.

Senator KASTEN. Let me answer your question specifically, Senator. The full taxation of gains, full deduction of loss with basis index from the enactment date. And a tax pair option during the 10-year transition period of 25 percent exclusion without indexing. It is not—it is generally the same—it is not precisely the same, and there is a slight change. And frankly, there is still a little bit of a complication—you could argue that there is a little bit of a complication in there. We did not change significantly the capital gains treatment.

Senator LONG. Under existing law, you pay taxes on only 40 percent of the gain. Would it remain that way in your bill?

Senator KASTEN. That would remain.

Senator LONG. All right. Thank you.

The CHAIRMAN. Senator Symms?

Senator SYMMS. Thank you, Mr. Chairman, and thank you, Senator Kasten, for your contribution here. My question is—and I couldn't disagree with you in any way that our Tax Code is too complicated and is a mess—but isn't it a fact that 70 percent of the people all pay the short form today?

So, there really isn't much of a change for that 70 percent. Isn't the 30% the people that file the long form and the corporate and the individual taxes for investments and so forth?

Senator KASTEN. I am not sure about the 70-percent numbers, but I know that a significant percentage—it is more than 50—of the people that now file the short form—either the 1040 or the 1040A or whatever--that a significant amount of the people—over 50 percent—that file the short forms need help to file their taxes. They are going to an accountant, a lawyer, or H&R Block.

Senator SYMMS. I guess what I am concerned about is coming from a resource-producing State, and many of the States in the

West either produce oil or different forms of minerals and timber—I am concerned about what the impact will be on resource-producing areas in the country in the raw material resource producers. Do you anticipate or have there been any studies that talk about—that point to—what this impact would be on the production of timber, on the production of minerals, on the production of oil, coal, and also on the production of agricultural products? What is the definition of income for, say, a farmer or for a miner or for a timber producer?

Senator KASTEN. We don't change the capital gains status or definitions or legal definitions of the timber, and so forth, and we maintain most of the ACRS system as it is. But specifically, I don't know of any studies that have been done.

Senator SYMMS. What happens to percentage depletion for the mining industry, for example?

The CHAIRMAN. It goes out. I think you eliminate that. Maybe it is phased over——

Senator KASTEN. We eliminate it, but it is an ACRS in the 3-year category. So, effectively we are dealing with the question and the problem.

Senator SYMMS. So, in other words, the investment tax credit would stay the same or does that go out, too?

Senator KASTEN. The investment tax credits would be eliminated. That would go out.

Senator SYMMS. OK.

The CHAIRMAN. Could I just ask one question? Then, we will move on to our witnesses. We have talked about a flat tax, FAST tax, FAIR tax—all these different proposals. And one thing that concerns many conservatives and others who are looking at all these is that once you develop this broad comprehensive income tax base and it has that rate, what is to prevent it from going up every year? I mean, it is going to be a pretty big temptation for Congress every year to go up another point or 2 points, and 10 points, depending upon what happens. Is there any way we can protect from that other than just hoping that we will be alert to any such change?

Senator KASTEN. Mr. Chairman, I think that if we had one rate that everyone understood, that there would be much greater pressure—public pressure—avoiding any tax increases, rate increases, or changes. Right now, we see people monkeying with the different brackets, the different questions. If everyone understood taxes were 25 percent across the board, that is the way it is going to be. Not some politician kicking it up to 27—I think they would have a more difficult time than they do today. So, I think if it is fair and simple, we would increase the understanding and the public's support for the system.

Now, it is so complex and complicated that we can increase different parts of it and call it something other than tax increase, and basically it will sneak through. If we have a fair and simple tax with a specific rate, I think it is a whole lot harder for the politicians to dicker with it.

Senator SYMMS. Mr. Chairman, could I ask one more question very briefly?

The CHAIRMAN. I just want to follow up. I think it is like the 3-cent stamp, you know. It did go up even though there was a lot of pressure. Then, we turned it over to some other group so we wouldn't have to put up with it in the Congress, but I think that is one valid concern. There is no way we are going to be able to guarantee that, once we establish a rate, that is the rate forever. And I think, however, that that is the purpose of these hearings. And we appreciate very much your comments.

Senator SYMMS. Mr. Chairman? I will just be very brief and make a statement. I think the chairman makes a very excellent point. My biggest concern about the whole thing is that I wish that the momentum in Washington were for spending reform which means reduction in spending instead of for tax reform because historically every time the politicians start talking about tax reform, a smart taxpayer grabs his wallet and runs for cover. Because every time we reform taxes, they go up. And that just historically has happened time and time again. And I hope that the momentum for this, which has a great deal of appeal to many of us, doesn't dampen the already dampened enthusiasm for spending reform because that is where Congress should be focusing their attention—is on the spending side. If we could get spending down, we wouldn't have to even have a meeting about taxes. But the problem is that we spend more than the revenues are generated at the present time.

The CHAIRMAN. I agree with Senator Symms. We shouldn't lose sight of the big problem we have, and that is spending.

Senator SYMMS. Maybe we could just take a different look at that and say that it is a legitimate concern that tax rates would go back up. And I think Senator Kasten admits that is a possibility, as anybody does who deals with legislative processes. It is also at least as real a possibility that various special interest groups will put their little thing back in the Code. If you look at where our tax expenditures have gone in the last 20 years, since 1967, it was $37 billion worth. And this year it is $240 billion worth.

The CHAIRMAN. Like the Olympic checkoff. [Laughter.]

Senator SYMMS. Well, we didn't make that. That was a good attempt, but we didn't make that. But the point is it is worth $240 billion—by the way, I might put that on this debt note—— [Laughter.]

The CHAIRMAN. Not until the elections are over.

Senator SYMMS. The point is that the tax expenditures are worth $240 billion. So, you know, the proposition is do you want to change the system? If you don't want to change the system, then you like high rates and a lot of loopholes. If you want to change the system, both have to come down. And once you have gotten a change, you can't bind another Congress. One other thing can come back. One, you can raise the rate. The other is you can get another loophole in. That is the nature of the process. The question is do you want to change or not?

The CHAIRMAN. Bob, we thank you very much.

Senator BAUCUS. Mr. Chairman, a question.

The CHAIRMAN. I would like to get to the witnesses if I can. I think you are all going to leave me here in about 20 minutes, and I will be all alone.

Senator **Baucus**. Mr. **Chairman**. I have a question if I might. Bob, will you retain ACRS and capital gains and some basic tax preferences? All the various proposals deal with the question of what preferences to retain and which preferences not to retain. All the various proposals deal with the question of what preferences to retain and which preferences not to retain. I am curious as to what criteria you have developed, what criteria you have followed to determine what tax preferences to keep in the code and which tax preferences not to keep in the code. What criteria are you using?

Senator **Kasten**. In general, we are trying to include tax preferences which provide incentives for activities that have made this economy stronger. Tax preferences for savings. Tax preferences for investment, and tax preferences for job-creating kinds of activities. You heard earlier in the testimony Senator Roth talking about the low savings rate. We have left the tax preferences for savings, specifically the IRA's, the Keogh's, and so forth. We want to have incentives in the system so that Americans will save in order to create a larger savings pool. We want to have incentives in the system so that Americans will own a home. We want to have incentives in the system for the basic kinds of job-creating activities. That is why——

Senator **Baucus**. I understand that and I think it is a noble purpose, but the problem that I have with that is that I think probably every preference that is now in the code can be justified on the basis of providing jobs and, you know, something that is good for America and so forth.

How do you distinguish between those that are better and those that are not quite so good?

Senator **Kasten**. I guess it is your choice or my choice, but I think that there are an awful lot of loopholes in the code right now that are not. The other thing I should say is that we wanted to keep preferences or keep deductions that benefitted a broad group of people, not a small special group of people. In other words, the IRA's benefit all Americans all across the board—not one specific group of people, not one specific income level. A large number of the deductions in the Tax Code—a large number of the preferences—benefit only a very narrow, small specialized group of people—a particular income group, a particular occupation, or a particular industry. What we have tried to do is to have broad kinds of deductions as well as savings and incentive oriented.

Senator **Baucus**. So, it is your view that keeping the ACRS system—retaining capital gains—is a broad-based incentive as opposed to some of the more narrow investment—not investment tax credits—but say, the conservation credits and so forth that are presently in the code.

Senator **Kasten**. Or you could go and look at all the individual kinds of things that have built up over the years. What we are taking is those exemptions that apply to everyone. I might say, very candidly, that a number of those exemptions that apply to everyone also are the most important politically. I don't think any flat tax program could pass. I don't think any flat tax program should pass that takes away the mortgage deduction and interest. I think home ownership is something that we want to have incentives in our system for, and I think we wouldn't be able to get rid of it even if we wanted to, but we shouldn't want to.

Senator **Baucus**. Do you provide a full deduction for mortgage interest?

Senator **Kasten**. Mortgage and all interest. Yes.

Senator **Baucus**. Thank you.

Senator **Kasten**. Mr. Chairman, thank you very much.

The **Chairman**. Thank you very much, and we appreciate it. Now, I know that a lot of members would like to make statements, so I wonder if we could agree that we could now call on members and limit the statements to 5 minutes Senator Packwood suggests a sort of a morning hour.

Senator Packwood, do you have a statement?

Senator **Packwood**. I have a very brief statement, Mr. Chairman. If we are going to move toward the flat tax or the FAIR tax or the FAST tax, or whatever it may be, I hope we are considering—as some of the later witnesses consider—whether or not we are going to destroy some incentives for very worthwhile purposes in this country. And I think that we ought to remember that there are only two ways we encourage things beyond the marketplace if we want to do it.

One is with tax incentives, and the other is with appropriated funds. And if any tax system runs the risk of destroying incentives for things that the bulk of this Congress thinks are worthwhile purposes, I hope everyone understands the consequences are then going to be more taxation and Government programs to accomplish the same thing that the Tax Code now encourages.

The Chairman. Thank you. Senator Danforth?

Senator **Danforth**. Mr. Chairman, let me express my appreciation to you for holding these hearings. I think that it is a very good sign, and my hope would be that we would be thinking in very broad terms about a major move to simplify the Internal Revenue Code. I have to admit that I am a convert in this area. I was not one of the first people to point the way toward tax simplification. At one point, I basically shared the position that was just taken by Senator Packwood that there are things that can be done through the Internal Revenue Code which are useful, but I have to say, Mr. Chairman, that the exercise that we went through in the 1982 tax reform bill and again in the 1984 tax reform bill is enough to make a convert of anyone. We enacted a bill this summer that was over 1,000 pages long. And that adds to a code which is now two volumes. This is the code without the new bill in it. Now, 20 years ago, when I was practicing tax law, the Internal Revenue Code was about the size of the smaller of these two volumes. and it is getting bigger and bigger. And I think that all of us on the Finance Committee have to admit that when we pass a bill as long and as complicated as the last one, there is no way that we can with really understanding fully what the effect of the legislation is going to be. And I say that with great respect to the Finance Committee. I think that the membership of the Finance Committee is excellent. I think that we have smart people on this committee, excellent staff. We are attentive. We show up at meetings, and yet I don't think that it is possible to pass a bill which is 1,000 pages long changing the Internal Revenue Code is hundreds of places and know what the effect of all those changes is going to be. So, I think that what we have done now is to create a situation in which Congress is not in a good position to legislate effectively because the Code is so complicated that we don't know what we are doing to it.

I also think that we have created a situation throughout the country where the race is to the swift. Really, the tax laws should be understandable to people. People should know what they are doing and know what they are paying, but I can't imagine that the American people—much less people who are in Congress—are going to be able to fathom something that is as complicated as the Internal Revenue Code is. I would also point out that one of the things that just amazes me when we are, say, marking up a tax bill or going through a tax conference is to look over the room, to look at the members of the staff of the Finance Committee and the Ways and Means Committee and the Joint Committee on Taxation—and many of the lawyers who are present in the room—and not simply notice the number of people, which is the thing that stands out readily, but the brilliance of the people. Those who have appeared before the Finance Committee representing the Treasury Department, the staff of the Joint Committee on Taxation, and so on are exceptionally able people. We have, I would submit, diverted the best and the brightest of our country into the practice of tax law. It requires not only detail work, but it requires tremendous imagination to be able to work your way around the Internal Revenue Code. Senator Packwood said—and I have to say that I used to believe this—that there are a number of socially desirable things that can be accomplished through the Internal Revnue Code, but it seems to me that one of the things that is not socially desirable is that diversion of so much brain power from useful things, such as teaching or developing computers or whatever into the Internal Revenue Code and its analysis. So, Mr. Chairman, I would hope that we in the Finance Committee could start a process where we would really start from scratch in rewriting the tax laws of this country. And I would hope that the new tax laws would approximate the size of the index of the Internal Revenue Code. I notice that the index is 60 some-odd pages long. Is it impossible to create a tax law that is 60 some odd pages long that everybody in the country can understand?

The CHAIRMAN. Thank you very much, Senator Danforth. In fact, the bill we passed was 1,309 pages long. I know I went out to make a speech to one of these accounting groups and I got a standing ovation before I said anything. [Laughter.]

So, they were very happy with it. Senator Long?

Senator LONG. No statement, Mr. Chairman.

THE CHAIRMAN. Senator Bradley? Do you want to summarize your visit to Minnesota? [Laughter]

Senator BRADLEY. Mr. Chairman, I don't know if you would be smiling or crying if I summarized the visit. It was very positive. Let me just follow on if I can Senator Danforth's comments, because I think that those comments are right to the point. The fact is we work in this committee room in Washington, and we sometimes forget that there are over 95 million taxpayers in this country who, every April, receive a thick booklet of instructions and say to themselves when they get the booklet: I am not using any of the provisions described in here but somebody is. I think that that basic unfairness and complexity is one of the major problems with the tax system today. And I know there are those who argue that the tax system should be complex and reflect the nuances of American life and so forth, but I frankly think it is that complexity that is, on the one hand, killing our entre preneurial spirit, and on the other hand, pushing us to extreme solutions. And I think that this committee's deliberation is very important, and as I look out there in the country today, not only do I see a burgeoning public interest in and support for change in the tax system, but I also see it coming from all segments of our society and from both sides of the political aisle, from liberals and conservatives who recognize that the American people want a system that is fair and simpler with lower rates. It is not lost on your average citizen who is paying an effective tax rate of 40 percent that he is paying for somebody else's free ride. And, indeed, if you look at the amount of revenue that the income tax system collects—a little over $300 billion—and you look at the amount of revenue lost through loopholes—about $240 billion—the numbers are there to support his suspicion that somebody else is getting a better deal than he is, and he is paying the freight of the higher tax rate.

So, it seems to me that the time is ripe for this committee to really exert some leadership to respond to what the people are feeling and to do it in a way that sends them the message not only that we are listening but that we are leading on this issue. And I have said for a couple of years now that this isn't a Democratic or Republican issue, this is an American problem. And it is crying for a remedy. As we begin our deliberations on this—and I think that 1985 will clearly be a very important year—I think there are a couple of things that we have to consider as we move to simplify the tax system and make it fairer.

One thing is I do not think we want to abandon progressivity. I think that we want to keep a tax system where those who earn a little more should pay a somewhat higher rate. I also think that we don't want a tax system that will increase the deficit, given the size of the deficits we already have. At a minimum it should remain revenue neutral. And I think that we don't want a tax system that preserves the kind of special benefits for one class—in many cases, the upper class—while leaving the middle class and the lower class with much higher rates of taxation.

And I think we also have to recognize that it will not be easy. There is a widespread belief that somehow or other the special interests have a lock on the legislative process in Washington. I don't think that is necessarily so. And I can't tell you how many people I have talked to in the last couple of years who, when presented with the option of a low rate or retaining their favorite deduction, have said they would prefer a low rate. And I think, therefore, Mr. Chairman, that these cynics are misreading the pulse of the country. And so, I welcome these hearings and hope that the legislative process eventually comes up with something that we can all be proud of.

The Chairman. Thank you, Senator Bradley.

Senator Chafee?

Senator **Chafee**. Thank you, Mr. Chairman. I also want to say I am glad we are having these hearings. Some here have been converted. Senator Danforth indicated that the light has struck and he has seen the path. I am looking for the path—which way to go. It seems to me that we all agree there have to be revisions in the code. We have got to do something. And it seems to me there are two approaches. One approach is to take the existing preferences, expenditures, credits, exemptions, deductions, and go through them and say all right, we shouldn't have this. Perhaps we should have this, but we shouldn't have the next one. That is one way to go, and we have found that that is excrutiatingly painful because when we consider the first one, the proponents of that one don't want to throw that one out or get rid of it because why offer theirs up for sacrifice if the later expenditures or credits might be kept. So, that is a very, very difficult way to go. The other way is to throw them all out, and to start with a clean slate. And really rewrite the code as Senator Danforth has suggested. And maybe that is what we have to do to get somewhere, but that in itself has a lot of problems. Now, Senator Packwood has suggested that we have got to be very, very careful. In the code are a whole series of incentives and that if they are not there, certain things won't happen—people won't take certain steps. I am not exactly sure that that is so. An awful lot of things were happening in this country—good things—before 1913 when the Internal Revenue Code came along.

And the classic example always given is charitable giving, and some people wept when we reduced the income tax rates, because if you took the rates down from 70 to 50 percent, people won't give so much money because the Federal Government is giving 70 cents rather than 50 cents of the dollar. I don't know whether that is true, and I would like to think that a lot of charitable giving took place in this country before there were any deductions. And what I think causes things to happen is that people have some money, and the charitable giving took place because there was money to give, rather than solely the incentives of the Internal Revenue Code. So, I just don't think that doing away with some of these incentives—these tax expenditures—every one of which has a proponent—a reason for existence—is going to wipe out the reason for that existence if indeed we make some fair revisions in the code and work it out so that the rates are reduced. So, I think this is an exciting endeavor and a lengthy endeavor. I don't think anybody ought to think that trying to change this code around is going to be simple. But I think while working on it, we will probably all get standing ovations from the accountants because they are interested in what we are doing.

The **Chairman**. I agree. I think it is going to be a long process, and we have avoided—we are not trying to answer some of the political questions that are floating around. We didn't ask the administration to come up and give their views. We are just trying to look at a number of options without advocating any. I mean, there are some advocates here, but there are a number of us who are trying to look at the whole horizon and see what we might be able to fashion and hopefully at least start the process early next year. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman. I am not going to prolong the discussion here. I think that we all agree on how complex the code is. Let me just add a couple of very small points here. First, I agree with the statements that have been made that the rates have to be lowered generally. I also agree that the rates have to remain progressive. I, however, think that we are going to have to retain indexing. I personally believe that that is a concept that must be in any future income tax system because our present system—up to this year, which we have not had indexing—allows Uncle Sam to get too much revenue that I think it should not earn. So, it should keep indexing.

I would also say that obviously nothing is going to happen this year, but I am reminded of an earlier situation earlier this year. I think that this committee frankly led the way to put pressure on the President, on the House, and other groups around the country to try to get the deficit a little bit lower than it already is. That is, we had a very strong bipartisan effort in this committee. Unfortunately, now in the campaign, one Presidential candidate says there are going to be tax increases this year, and the other—I am not sure what he says. Sometimes he says there won't be, but other times he is not so sure himself. But the point is that the issue is getting polarized, and I think that next year when we do meet to take some action, in addition to having hearings, that it is a good opportunity for this committee to again lead the way on a bipartisan basis.

Senator Bradley is correct. This is an American problem. It is not a Republican problem. It is not a Democratic problem. Liberal or conservative. It is an American problem, and I think we can provide a good service to our country if when we meet next year we approach it that way—as an American problem on a bipartisan basis. It is not going to be easy. It is a very complex problem. I am reminded of a Baltimore Sun journalist, H.L. Mencken, who said for every complicated problem, there is an easy solution, and it is usually wrong. Although I do think this is a case where we can use more simplicity than we have in the past.

So, I just commend you for holding the hearings, Mr. Chairman. And I urge us to put partisanship aside this year, but particularly next year, when we have got to buckle down and do the work. Thank you.

The CHAIRMAN. Senator Grassley?

Senator GRASSLEY. Mr. Chairman, I feel so frustrated about the Tax Code that I think I would almost consider any alternative to what we have now as a way of simplification, but I am terribly pessimistic about the chances of accomplishing much in the way of tax simplification. My reason for being pessimistic, I suppose, is somewhat related to how you measure how bad the situation is, and I think Senator Danforth had a very good measure—the size of the code. But also, in the 4 years that I have been on this committee, I have seen the line of lobbyists and interest groups lined up outside of this room that are trying to get in here, and I have seen that grow longer during my period of time. It is almost as if you can measure how serious the problem is, not only by the size of the Tax Code, but how long the line of special interests who have an interest in whether or not we are going to simplify the system. And it is because of that line and each loophole having its advocates here in Washington and at the grassroots that causes me to be pessimistic about an opportunity for change because someone sees their interest being hurt as a result of tax simplification. It is an oddity that in the hearings that I have had in my subcommittee on the subject of how the Tax Code affects productivity. We have everybody testify that in some way the Tax Code does inhibit productivity, and yet we can still have people come and say, you know, we think it ought to be simplified, but our provision ought to be maintained. It is just a little bit like everybody coming around the office saying that, yes, I think the budget should be balanced, but I think that we ought to spend more in this area because it has such a social good. And that is basically like saying, you know, the job will never be done as long as people still look at their own little special interests.

So, I am pessimistic, and I think that without strong Presidential leadership, we won't have it regardless of our constitutional responsibility of leadership within this committee, that Senator Bradley begs for, and I don't disagree with him. I think it is going to have to come outside of this room as evidenced by the interests here that want to keep the status quo. I think that not only beyond Presidential leadership, but I think we are going to have to see a prairie fire from the grassroots in support of reform even more than we have seen to this point. And we have seen more now than ever before that I can imagine. So, it is going to have to be leadership beyond this committee, and most of all it is going to have to be the—how do you say it?—the withdrawal of our own special interests if anything is really going to be accomplished.

The CHAIRMAN. Thank you, Senator Grassley. Senator Symms?

Senator SYMMS. Thank you, Mr. Chairman. Mr. Chairman, I want to compliment you for having these hearings, and I am not quite as pessimistic as my good friend from Iowa is. I think we can do something about this, but I think we have to separate the illusion from what the reality is. And there is an illusion somehow that all we have to do is just simplify the Tax Code and go to a flat rate tax and then there would be no problems. The complicated side of the Tax Code is on the business side, and the problems like, for example, in my State where we are a big mining State, where 50 percent of the cash flow for the mining companies provide jobs for my constituents comes from investment tax credits right now. Those kinds of things have to be looked at and answered.

It is also a fact that about 50 percent of the individual income that is generated by Treasury, I believe, is coming from the top 10 percent of the taxpayers. I don't have those figures, but it is about that. So, we have got to be a little bit careful or this could end up being a tax increase on middle America. We have to be not a little bit careful, but I think the Chairman talked about we have to be a lot careful so that doesn't happen. And then the third thing that I would like to comment on is I would like to compliment our colleague on the committee, Senator Roth, for his point that we have got to encourage a Tax Code that encourages savings. And I think that I have been working with some of the things Senator Roth has been doing, and my staff has, and I want to approach this on the business side also. You know, coming from a farming State, I watched farm cooperatives be able to accumulate capital because of the Capper-Volstead Act in competition with people that are not cooperatives, and anybody that is in a farm co-op understands that they can accumulate capital because what it really is—it is a corporate tax that only taxes on the dividends. It doesn't tax the corporate side is really what it amounts to, so they can go out and build a cold storage plant or build a potato warehouse or whatever it is, or a grain elevator, and take their earnings and put it right into the building. That is what we need to do with the corporate side of our tax—is encourage corporations to be able to take some of their earnings and invest it in plants and equipment without having to pay 50 percent of it back out in taxes. And once we get to that point, we will see a booming economy. But I would say, as I said at the beginning, my advice to my constituents always is when Congress talks of tax reform, grab your wallet and run for cover. And I just would appeal to my colleagues.

Let's don't allow this to get out of hand and just be a giant tax increase on the hard-working Americans. What we need is a continuation of the direction we have been going. And maybe what we need to do is just lower all rates 1 or 2 percent and include the corporate side and the private side and not change this 1,100-page document because sooner or later people will learn how to live with that. If we just stop changing it every 15 or 20 minutes. They don't change the rules at the Olympics every day. They play by the same basketball rules and by the same baseball rules and other sports, but what we do is, as soon as they learn the rules, then we want to change them. And it just makes it so complicated. I think we over—we make it more complicated than necessary. So, I think these hearings are important. I know this committee will look at it very carefully, and then I would say, at the end, before any bill is ever passed around here, we might as well start telling our constituents, and I tell mine this, that the illusion that we talk about with the flat rate tax, once all the people find out whether they are going to get an increase or decrease, then you will find out how many votes there are in Washington to pass the tax. And if it is going to be a tax increase, it isn't going to wash.

The CHAIRMAN. Thank you, Senator Symms. I would like put in the record a statement where I have tried to outline at least some of the options we have and raise some of the questions that Senator Bradley has already raised on progressivity. I think we have to address that. Are we going to have it or are we not? There is a difference in views.

We have to determine how much a gain in simplicity and economic efficiency can be achieved by streamlining, moving to a low rate or flat rate structure or a system of taxes on consumption. And we have to get into defining income. That is not very easy to do. And then you look at some of the areas that are not now taxed. And I would say that there are a number of specific ways in which a lower rate or consumption-based tax system might be structured. Either have a single rate to a comprehensive base—that would mean everybody paying the same proportion of income in tax—or change the types of things that we tax. I am just suggesting some of the options. In the alternative, you could have rates reduced and the base broadened by eliminating a range of tax preferences. We have been trying to do that. So, I guess we all agree we want greater equity in the Tax Code and a simpler system.

So, I have tried to boil it down to about three different things we will probably have to consider. If we continue to work through the Tax Code on an item-by-item basis, which would not please Senator Danforth and many of the rest of us find that pretty difficult to do—we could continue our base broadening, which we think has been fairly effective. We have closed a number of gaping loopholes. It does bring about a certain amount of equity and some simplicity, but it also adds to the code, which is probably an error that we ought to take a look at. Some would suggest that we just agree on a major revision of the system in the direction of lower rates and a broader base or a consumption base and take the necessary steps to implement such a system. That would be, I think, rather difficult to do all at once, but it is an area that I think we ought to take a hard look at. I share some of the concerns expressed by Senator Symms. I think in the final analysis whether someone is for or against the flat, the FAIR, the FAST tax, is going to depend on how much tax they pay. I think everybody now has the perception they are all going to get a tax reduction, and I don't see how that is possible. Then, we could always do what I think we might do in this committee, and that is proceed in a couple of ways—continue a step-by-step base broadening as we have been doing in the past 3 or 4 years, along with a major simplification where you would have it phase in over a period of years, but I guess the important thing is that we need to find some consensus in this committee. No doubt, this committee and the Ways and Means Committee will provide the leadership, whether it is Mondale or Reagan in the White House, they will finally come to this committee and to the Ways and Means Committee. And who knows—until we look at the election returns and the makeup of Congress and the makeup of the White House—just what tax policy we will be looking at. But I am convinced, whether it is Republican or Democrat, there is a big consensus—or fairly large consensus—to do something, and that is the purpose of this round of hearings. And we are happy to have as our first panel James B. Lewis, chairman-elect, Section of Taxation, American Bar Association, Marshall Blume, Howard Butcher professor of finance, the Wharton School, and Randall Holcombe, Ph.D., associate professor of economics at Auburn University.

What I have asked the witnesses to do is to very quickly summarize their statements on the theory that we can all read and be able to read their statements and give us some time to ask some questions because there are a number of distinguished witnesses who would like to be heard while a number of us are here. So, we hope we can proceed on that basis.

We will start with Mr. Lewis. Thank you very much for coming.

Senator LONG. Mr. Chairman, could I make a suggestion? We have some outstanding people here who have prepared some very thought-provoking statements that should be considered.

I would hope that all of us on the committee would limit our questions to the extent that we can in good conscience do so, and give these distinguished witnesses a chance to appear at a time when the media is here and when Senators are here. I don't quite know how it happens, but everyone is here when we start out, and by the time we get about a third of the witnesses heard, the cameras are all gone. I would hope to try to give all the witnesses a chance to appear while somebody is around here to hear them, and that we all try to limit ourselves in the questions that we ask these distinguished witnesses until all have been heard.

The CHAIRMAN. And we are saving a lot of the explosive stuff until the last today. [Laughter.]

Mr. Lewis.

STATEMENT OF JAMES B. LEWIS, CHAIRMAN-ELECT, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, WASHINGTON, DC

Mr. LEWIS. Mr. Chairman, and members of the committee, my name is James B. Lewis. I am chairman of the Section of Taxation of the American Bar Association and am pleased to submit the views of that organization on basic tax reform.

A few days from now, on August 16, the Internal Revenue Code of 1954 will be 30 years old. The code is not in good health. The principal ailment from which it suffers is the multitude of tax preferences that have been enacted into the income tax law. Most of them, when examined individually, serve legitimate social or economic purposes. The dead weight of these preferences, however, has enormously increased the complexity of the income tax law, has led to a second round of complexity consisting of provisions enacted recently to limit some of these preferences, and also has created the perception that the income tax is unfair and this has eroded compliance. So, I think that drastic action is now necessary to simplify the law, to broaden the tax base, and to lower the rate structure. The Section of Taxation applauds the action of this committee in scheduling these hearings on basic tax reform, and we assure you of our desire to be of constructive service in the pursuit of that goal. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. We appreciate that, and we hope to have time for some questions from each one of the members.

Mr. Blume?

[Mr. Lewis' prepared written statement follows:]

STATEMENT OF

JAMES B. LEWIS

CHAIRMAN

SECTION OF TAXATION

AMERICAN BAR ASSOCIATION

Summary of Statement of James B. Lewis

Mr. Chairman and Members of the Committee, my name is James B. Lewis. I am Chairman of the Section of Taxation of the American Bar Association. I am pleased to present the views of the Section on basic income tax reform.

On August 16, just a few days hence, the Internal Revenue Code of 1954 will attain its 30th birthday. Unfortunately, the Code is not well. Largely as a consequence of a multitude of tax preferences, the law has become unacceptably complex, and the tax base has become unnecessarily narrow, requiring higher tax rates than would otherwise be necessary. While most of these tax preferences seek to implement desirable social and economic objectives, it is doubtful that all of them can be accommodated within a fair and efficient revenue raising system.

Drastic action is necessary to simplify the law, to broaden the tax base, and to adjust the rate structure. The Tax Section offers to this Committee, to the Congress and to the Executive its considerable technical skills to assist in the accomplishment of these important objectives.

My prepared statement outlines our views on the nature of the problems embedded in the current system and our suggestions as to the kinds of corrective action that may be responsive to those problems.

We applaud the action of this Committee in scheduling hearings on basic tax reform, and we assure you of our desire to be of constructive service in the pursuit of that goal.

Statement of James B. Lewis

Mr. Chairman and Members of the Committee, my name is James B. Lewis. I am Chairman of the Section of Taxation of the American Bar Association. I am pleased to present the views of the Section on basic income tax reform.

On August 16, just a few days hence, the Internal Revenue Code of 1954 will attain its 30th birthday. Unfortunately, the Code is not well. Over the past thirty years, it has been transformed from a moderately complex collection of laws designed chiefly to raise revenue into an extraordinarily complex collection of laws that not only raise revenue but serve a number of other social objectives. Even experts now have difficulty in understanding and applying the extraordinarily complex provisions of the Code.

Contrary to popular notion, tax professionals neither endorse nor benefit from this state of affairs. The American Bar Association has adopted a policy position that advocates simplification of the tax laws. The Tax Section of the ABA has advocated particular simplification programs and has worked closely with the Congress and the Administration to secure their enactment. We will continue to press for simplification, and we endorse strongly the efforts of this Committee to move in that direction.

The chief source of tax complexity lies in the wide range of special tax preferences for both individual and business taxpayers. While continuing to be called an "income" tax, the tax is instead imposed on only a limited portion of "income" by reason of the many exclusions and deductions that very substantially narrow the base on which the tax is ultimately imposed. Moreover, the tax imposed on this narrowed base is eroded by the availability of a variety of credits against the tax. These exclusions, deductions and credits both reduce the revenue yield from the income tax and create major complexity within the statute.

They also generate a second level of complexity. Taxpayers naturally strive to take maximum advantage of tax preferences, to the end that they often claim them in respect of transactions that were not intended by Congress to produce tax advantages. This factor in turn has required enactment of restrictive legislation designed to "fence off" these preferences from unwarranted enjoyment by ineligible taxpayers. Finally, the scramble to take advantage of these tax benefits induces widespread noncompliance, requiring enactment of penalty provisions that seek to buttress a system originally premised on notions of voluntary compliance.

Special tax preferences thus not only narrow the tax base and reduce the tax yield. They also create complexity, first by reason of their very existence, second by reason of the defensive mechanisms that they necessitate, and third by reason of the compliance problems to which they contribute.

To state this problem is simple; to identify the appropriate solution is more difficult. The present structure did not grow irrationally. Each tax preference was crafted to achieve an identifiable and often laudable social or economic purpose. Most can still be defended by reference to these purposes, and the constituency of any of them that would be affected by repeal can be expected to defend it vigorously. Major change is thus difficult. Nonetheless, the situation is serious and corrective action should be taken.

The central question is not whether the social and economic objectives facilitated by tax preferences are desirable but rather is whether a tax system that accommodates all of them can be a workable system. Current indications are that it cannot. If that is indeed the conclusion, the major principal alternatives are to make base-broadening and simplifying changes in the existing system or to move to an altogether different system, for example, a consumption tax. A third approach would be to retain the existing income tax and to adopt a companion tax, such as a value-added tax, designed to raise additional revenues. This, however, would do nothing toward rectifying the complexity and compliance problems of the income tax, which should in any event be addressed.

The choice among alternative tax systems involves major differences in the distributional effects of the tax burden on various classes of taxpayers. The Tax Section is not well equipped to assess the merits of these distributional effects and thus we do not, as a matter of policy, address the question of which tax system would best serve the national interest. Within any of the systems, however, we are competent to address structural and tax policy issues designed to facilitate simplicity, administrability and equity. The Tax Section is anxious to work with the Committee and its staff to achieve these goals within any tax system that is preferred.

The term "flat tax" has been used in much of the recent dialogue surrounding tax revision. This may be a misleading term. A simple tax system can exist even with a concept of progressivity in rates. The complexity of the current system does not result in any important respect from the graduated rate structure -- it results instead from the exclusions, deductions and credits that narrow the tax base, reduce the tax yield, and spawn statutory complexity. Accordingly, the question of rate structure should be addressed after the simplified tax system has been identified -- it should not be the driving force in identifying that system.

Although progressivity in rates may be acceptable in a simplified tax system, substantial broadening of the tax base would permit rate reduction which could yield further simplification benefits. Rates that are too high motivate taxpayers to engage in avoidance activity that in turn requires restrictive and complex legislative response. Thus, one benefit of base broadening could be a rate structure that, although progressive, is not excessively high in any income bracket.

In adopting major tax reform, Congress will necessarily encounter difficult transitional problems. Those problems are probably maximized by a wholesale shift to a new system (e.g., from an income tax to a consumption tax) and minimized (though not eliminated) if the current system is retained but drastically overhauled. If there is a shift to a consumption tax, taxpayers who have saved under the income tax from their after-tax dollars would have to be protected from tax when they withdrew and consumed those savings under a consumption tax. Transitional problems of this magnitude are avoided if the focus remains an improved income tax, though they are not even then altogether avoided.

The problems of low-income taxpayers will require attention under any new system, and consideration will have to be given to exemptions, deductions, or graduated rates designed to exempt from tax certain minimum levels of income. Moreover, questions will arise as to taxability of welfare payments, unemployment compensation, and public retirement benefits, as well as to the deductibility of child care expenses and private retirement savings.

Issues relating to the taxation of business enterprises must be addressed and resolved. These include integration of the corporate and individual tax systems, evaluation of methods for taxation of foreign persons and foreign earnings, and examination of capital cost recovery concepts and related questions of inflation. The concept of a preference for taxation of capital gains, weighed against the complexity that the preference mandates, must be evaluated. Major changes in the income tax system will also require concurrent evaluation of the estate and gift tax system to insure, at a minimum, inter-system harmony. For example, if gifts and bequests were not to remain as exclusions from the income tax base, the impact of the transfer tax would have to be evaluated.

The Tax Section offers you its cooperation and support in this important endeavor.

STATEMENT OF MARSHALL E. BLUME, PROFESSOR OF FINANCE, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA

Mr. BLUME. Good morning, Mr. Chairman and members of the committee. I am Marshall Blume, professor of finance at the Wharton School and chairman of the Finance Department. I have submitted prepared testimony, and let me briefly summarize the two principal points in that testimony.

My first point is that all investment income from whatever source should be taxed at the same reasons of allocational efficiency. Currently, our system is far from that ideal. Capital gains are taxed at one rate, but dividends at another rate. Corporations are allowed to deduct interest payments but not dividends. IRA's and pension funds are taxed as they would be under a consumption tax, while other types of investments are taxed on an income tax basis. Parenthetically, I might note that a fully integrated consumption tax or a uniform value added tax would be consistent with this principle.

My second point is that there is no theoretical reason to believe that an increase in the rate of return on capital—possibly brought on by a reduction in tax rates on capital—would result in an increase in the savings rate. It is ultimately an empirical question, and the empirical results are mixed, suggesting no strong relationship. More pertinent to the setting of the overall tax rate on investment income are factors such as the distribution of income, allocational efficiency, tax simplification, and transitional costs and problems of any change. Thank you.

The CHAIRMAN. Thank you very much.

Mr. Holcombe?

[Mr. Blume's prepared written statement follows:]

COMMENTS
OF
MARSHALL E. BLUME

Howard Butcher Professor of Finance
The Wharton School
University of Pennsylvania

Today, I wish to discuss two basic principles concerning the taxation of investment income. In investment income, I include all types of return to savings, including capital gains. The first principle is perhaps less controversial than the second, and thus is a good place to begin my comments.

The first principle is that the tax system should be as neutral as possible with respect to how savers allocate their investments. Currently, the tax rates on investment income vary widely according to the source of the income and undoubtedly influence the types of new investments undertaken. Interest on muncipal bonds is free of Federal tax, while interest on Federal and corporate debt is subject to the individual income tax. Dividends are taxed at one rate, and capital gains at another rate. A complex set of depreciation schedules and tax credits makes certain types of investments more profitable than others.

Corporations can deduct interest paid but not dividends in calculating their tax liability. This provision makes it less costly to invest in those projects that can carry substantial debt. Individuals are allowed to deduct interest and taxes on their own homes, but do not have to report the imputed rent. Provisions in the tax law, such as these and many others, favor certain types of investments. Indeed, some investments--so-called tax shelters--may be undertaken for tax reasons alone.

If investment returns were certain, as is assumed in many models, a neutral tax system would be one that applies the same tax rate to all investment income, regardless of source. However, investment returns are usually uncertain. In this case, neutrality is no longer as well defined. The reason is that taxes affect not only the expected after-tax return, but also the risk of those returns through loss offset provisions of the tax code.

Depending upon the investor's tradeoff between risk and expected return, changes in tax rates, even if the same for all investment income, may induce investors to take on more risky projects or to take on less risky projects. In other words, increasing or decreasing a tax on investment income will initially change the relative values of existing assets of different risks and ultimately the composition of new investment. Under one plausible model, an increase in the tax rate on investment income would lead to an increase in the relative values of existing risky investments and finally to increased new investment in risky projects.

In sum, any tax on investment income, other than zero, will affect both the expected return and the risk of existing and new assets. Depending upon investors' willingness to bear risk, any change in the tax on investment income is, at least theoretically, likely to affect the proportion of savings flowing into risky investments, and thus be non-neutral. Yet, if it is desired to tax investment income, it is probably best, given our current state of knowledge, to try to tax all investment income at the same rate.

The second principle that I wish to discuss today concerns the relationship of savings rates to after-tax rates of return on investment income. Although it is frequently stated that higher after tax rates of return will generate increased savings, there is no obvious theoretical reason to believe that this will happen. In a world of certainty, it has been pointed out on occassion that an investor who receives a greater rate of return than formerly need not save as much as before to realize the same level of wealth. In short, there is both an income and a substitution effect. The income effect encourages savings, while the substitution effect discourages savings.

In a more realistic world that includes uncertain returns, the theoretical argument is more complex. As already pointed out, a tax on investment income affects both the return that is expected as well as the risk of that return. Depending upon the assumed risk tolerances of investors and the available investments, it is possible to devise theoretical models that lead to increased savings, decreased savings, or no effect.

Thus, the relationship of saving rates to tax rates is ultimately an empirical question. There are some studies that show that decreases in tax rates stimulate savings, while there are others that show the reverse. Indeed, slight changes in the definitions of the variables or in the specification of the model can radically change the conclusion.

What these often conflicting results mean to me as an economist is that the relationship between tax rates and saving rates over the ranges that we have observed in this country is not strong. Even the direction of the relationship is not clear.

In conclusion, the tax rates on investment income currently vary substantially from one investment to another. Any reform of the tax system should try to equalize these rates. Both theoretically and empirically, there appears to be no strong relationship between tax rates and overall savings. Thus, the desire to increase savings gives us little guidance as to what should be the overall tax rate on investment income. We must consider other factors, such as the effect on the distribution of income, on the allocation of new investment, and on the complexity of the tax code.

If it is desired to move in the direction of a consumption tax, the rate should be set to zero. If it is desired to utilize income as the base for our tax system, then investment income should be taxed at the same rate as any other type of income. In any case, the current array of taxes on investment income should be replaced with a single uniform tax to make the tax code as neutral as possible.

STATEMENT OF RANDALL G. HOLCOMBE, PH.D., ASSOCIATE PROFESSOR OF ECONOMICS, AUBURN UNIVERSITY, AUBURN, AL

Dr. HOLCOMBE. Mr. Chairman, members of the committee. In the brief statement that I have today, I want to discuss some issues related to the flat tax, and since my remarks now must be brief, let me focus on some of the distributional and fairness issues that have been raised. Income tax systems in general have a limited ability to redistribute income. Wages are paid in different amounts to different individuals to compensate them for the differences in their jobs. Since workers care about their income after taxes, not before, a more progressive tax structure will cause a more unequal pretax distribution of income to compensate higher paid individuals for their higher taxes. Under any tax structure, the aftertax distribution of income will be roughly the same. Thus, the adoption of a flat rate tax will not have a significant impact on the aftertax distribution of income.

As we have heard many times today, the flat tax is simple. It lowers marginal tax rates and it broadens the tax base to enhance its revenue-generating potential.

My written testimony provides more details of my argument and I ask that it be included in the record, and I would be happy to address other issues if you have any questions.

The CHAIRMAN. We do have some questions. Your statement will be made part of the record.

[Dr. Holcombe's prepared written statement follows:]

THE DISTRIBUTIVE IMPLICATIONS OF A FLAT RATE INCOME TAX

Statement before the

United States Senate
Finance Committee

Hearing August 7, 1984

Submitted by: Randall G. Holcombe
Department of Economics
Auburn University
Auburn, Alabama 36849

Flat rate income taxation is an idea that has seen increased political popularity in the past few years, and rightfully so. A true flat tax has many advantages over the current tax system, and almost no disadvantages. Any change in the existing tax law will produce gainers and losers: this would be true with the introduction of the flat rate tax, as well as with any other type of tax reform. The distributional implications of any tax system are important. A tax system must be fair as well as efficient. Some individuals, while seeing the efficiency benefits of a flat rate tax, have expressed some concern about its distributional implications. Specifically, they are concerned that a flat rate tax would place additional burdens on lower income taxpayers, while reducing the taxes of higher income taxpayers. My main message today is that the distribution of tax payments by income groups under a flat rate tax would be essentially the same as under the current income tax system. Thus, there are no major distributional impacts to be concerned about with the flat rate tax.

I would like to begin by briefly reviewing some of the advantages of the flat rate tax, even though they are probably well known to members of the committee. Then I will discuss the distributional implications of the flat rate tax in more detail.

Some Advantages of a Flat Rate Tax

There are many different proposals for flat rate taxation. I will use as a model for my discussion the proposal by Hall and

Rabushka.[1] Most of the advantages of the flat rate tax stem from two of its features: it has a low marginal tax rate, and it eliminates almost all deductions in figuring taxable income. A third desirable characteristic which is a part of the Hall and Rabushka proposal (but not of many other proposals) is that it eliminates the double taxation of income that occurs for many types of income under today's tax rules.

The low marginal tax rates inherent in a flat rate system enhance the incentives to earn additional income. The argument as it relates to high income earners is familiar, and also significant. The most productive individuals in an economy are also among the high income earners, after all. But low marginal tax rates are also significant to households with two income earners, and the present tax system is very hard on married women who want to enter the labor force. Because a second income earner's income is added to the primary income earner's for tax purposes, this discourages the secondary worker from entering the labor force, and especially discourages the household from investing in enhancing the productivity of the secondary worker, for example, through education. Since most secondary workers are wormen, the flat tax would treat women as a group much more fairly, and would encourage more investment in the income earning skills of women, thus taking a step toward narrowing the income gap between women and men. And because of lower marginal tax rates, the incomes of all groups would be expected to increase.

The flat rate tax is also designed to provide incentives for productive activity rather than tax avoidance. Partly, this is due to the low marginal tax rates, which make tax shelters less valuable. It is also partly due to the elimination of most deductions under the flat rate plan. Payment of employees through in-kind benefits, sock options instead of salaries, and so forth, is largely due to the tax system which enables some or all of the tax on this type of income to be avoided. With a flat rate tax, the incentives for tax avoidance are reduced, and the incentives for productive activities are increased. The same is true with individual income as well. With high marginal tax rates, individuals are lured into sheltering their income from taxes to such an extent that Hall and Rabushka (p. 13) note that in 1979 itemized deductions reduced adjusted gross income by 23 percent. By eliminating these incentives for tax avoidance, the flat tax makes more income subject to tax, and thus allows it to be taxed at a lower rate.

Numerous other advantages could be mentioned, such as the reduced burden of tax preparation, a reduced incentive to cheat on taxes, and reduced interest rates because interest expenses would no longer be deductable.[2] At this point, however, I want to turn to the distributional issues.

Distributional Issues and the Flat Tax

The first thing to note regarding the distributional issues surrounding the flat tax is that the current system of progressive taxation does not redistribute very much income. Despite progressive marginal tax rates, deductions and tax credits are much more available to high income earners than to low. Thus, Browning and Johnson[3] have estimated, when considering all major tax sources, that average tax rates do not differ much for most of the population. Table 1 summarizes their estimates, breaking the population into quintiles by family.

Table 1

PERCENT OF INCOME PAID AS TAXES

Quintile	1	2	3	4	5
Average Tax Rate	28	28	29	30	38

Browning and Johnson go on to estimate that the cost of redistribution under today's tax system is extremely high. They estimate that for each dollar of disposable income redistributed to the bottom quintile of families, the disposable income of upper quintile families is lowered by $9.51 as a result of the disincentive effects and inefficiencies built into the present system.

It is one thing to argue that the present system does not redistribute income effectively, but a stonger argument can be made, that an income tax system inherently has limited ability to redistribute income. The reason is that the wages paid in any occupation are determined by the forces of supply and demand. Any employee will typically have an array of employment possibilities, some paying more than others. The higher paying opportunities pay more in compensation for the nonpecuniary differences among occupations. Workers care about their incomes after taxes, rather than their incomes before taxes, however. Thus, the differential compensations among jobs will have to be differentials in after tax income rather than before tax income.

The result is that if tax rates are made more progressive, those in higher paid occupations will have to be paid additional pre-tax income to compensate them for the higher taxes that they now must pay, in order to maintain the after tax pay differential that attracted them to the occupation in the first place. In other words, the more progressive tax rates are, the more unequal before tax incomes will be, in order to compensate higher paid workers, in after tax income, for their work. The implication is that any change in the distribution of income induced by the flat tax would be compensated by an offsetting change in pretax income.[4] A more progressive tax would lower the number of workers in higher paying jobs,[5] but the relative wages to occupations would remain roughly constant after taxes, increasing the inequality of wages before taxes.

There is some evidence that this has occurred in the United States. Reynolds and Smolensky[6] found that since World War II, the U.S. income tax structure has become more progressive, and that at the same time the pretax distribution of income has become more unequal. However, they also find that after taxes and government transfers, the distribution of income has remained virtually unchanged. In other words, government programs have moved in the direction of trying to redistribute income, but changes in before tax incomes have essentially offset the government's distributional attempts.

My argument above explains why. People demand compensation net of taxes, so when the tax structure becomes more progressive, the before tax income distribution becomes more unequal to compensate higher income individuals for the additional taxes that they have to pay. This makes the tax system ineffective as a distributional tool. I have given some references to the works of other economists supporting this idea (see footnotes) to indicate that this is not just some idle conjecture, but an idea substantiated by economic theory, and supported by empirical evidence. The bottom line on this is that if our present tax system were replaced by a flat rate tax system, there would be very little effect on the after tax distribution of income.

Conclusion

The flat rate tax has a number of attractive features, but some are concerned that if enacted, the tax burden on lower income individuals would increase, while the rich would pay lower taxes. My argument suggests that this is not the case. First of all, the present tax system does not redistribute much income, because although marginal tax rates rise with income, higher income people are also better able to use the complex tax structure to avoid paying taxes. This argument aside, however, a progressive tax system of any kind does not have much of an ability to redistribute income. People demand compensation for their work in after tax dollars, so a more progressive tax system will simply cause pre tax earnings to be more unequal to compensate higher income individuals for the more progressive tax system. A flat tax system would have a minimal impact on the number of tax dollars paid by each taxpayer,[7] but even this effect could be expected to be offset by adjustments in before tax incomes. In short, there should be only minimal concerns, at most, about the distributional impacts of the flat tax, because a flat tax would have very little effect on the after tax distribution of income.

FOOTNOTES

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1. Robert E. Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax*, (New York: McGraw-Hill, 1983).

2. See Hall and Rabushka, pp. 60-62 on this point.

3. Edgar K. Browning and William R. Johnson, "The Trade-Off between Equality and Efficiency," *Journal of Political Economy* 92, No. 2 (April 1984), pp. 175-203.

4. Milton Friedman, *Price Theory* (Aldine: Chicago, 1976), p. 247, notes this same phenomenon.

5. See Richard E. Wagner, *Public Finance* (Boston: Little Brown, 1983), pp. 196-201, on this point.

6. Mogan Reynolds and Eugene Smolensky, *Public Expenditures, Taxes, and the Distribution of Income* (New York: Academic Press, 1977).

7. See Hall And Rabushka for estimates on their particular proposal.

The **Chairman**. We will start with Senator Packwood.

Senator **Packwood**. No questions.

The **Chairman**. Senator Roth?

Senator **Roth**. No.

The **Chairman**. Senator Chafee?

Senator **Chafee**. No questions.

The **Chairman**. Senator Grassley?

Senator **Grassley**. No.

The **Chairman**. Senator Heinz?

Senator **Heinz**. No.

The **Chairman**. Senator Symms?

Senator **Symms**. No.

The **Chairman**. Senator Long?

Senator **Long**. No.

Senator **Bradley**. Mr. Chairman, I think it would be a real disservice to have these three gentlemen before us and not spend some time to ask some questions because I do think that they have provided some very thoughtful——

The **Chairman**. Yes, we will have questions. We have asked them to abbreviate their testimony so that we could ask some questions.

Senator **Bradley**. In fact, I think that is an all-time record for a panel. [Laughter.]

Let me ask Mr. Blume a question. I did have a chance to read your testimony before the hearing, so I didn't have to rely on the brief summary that you gave the committee. It seems to me that what you are saying is that this committee has a threshold choice to make as we look at the whole issue of tax reform: either to go with a consumption-based tax that would not tax savings and investment, or to stick with an income tax that has a uniform rate of tax on all income. That is a threshold question. And what I would like to ask you is: Is that correct?

Mr. **Blume**. Yes. Certainly, that is a basis. Right now, our system of taxation includes both types of taxation—consumption and income tax taxation. We should move toward one or the other at a uniform rate.

Senator **Bradley**. And as you stated in your testimony, if we are going to have an income tax, it should have a uniform rate on all income. That means that we would have the same treatment for wages, dividends, capital gains, interest and so on—is that correct?

Mr. **Blume**. Yes, that would be correct.

Senator **Bradley**. What would you say to those individuals who argue that the capital gains differential is very important and that the tax rate on capital gains should be much lower than the tax rate on other income?

Mr. **Blume**. It is certainly true that differences in tax rates motivate how people invest their savings. People go to great lengths to change ordinary income into long-term capital gains. I think those are called tax shelters. They pend a great deal of effort and time. Some of the investments that they undertake are motivated more for tax reasons than necessarily for economic efficiency. If the tax rate were the same on all investment income, you would find that people would start to make investment decisions based upon the economic merits of the investment and not necessarily an incentive from Congress.

Senator **Bradley**. So, your argument is that if we do go the income tax route, we should have a uniform rate on all kinds of income because that is best from the standpoint of economic analysis and economic growth. Is that correct?

Mr. **Blume**. Yes, subject of course to making sure that the distribution of income is acceptable to the body politic.

Senator **Bradley**. All right. Now, you said something else in your testimony that I found especially interesting, particularly given what we hear in the committee frequently about our low savings problems and about the higher savings rates in Germany or Japan or somewhere else, and how that is the reason for our alleged lack of competitiveness or whatever the argument is made at that point. But you said in your testimony that there is no empirical evidence that changes in tax rates affect overall savings levels. Is that correct? And could you explain why you think that?

Mr. **Blume**. Most of the large-scale econometric models, such as the Wharton model or the MPS model, do not have a very strong interest rate effect in the consumption equation. In other words, what that means is that the level of interest rates doesn't influence very dramatically the level of consumption and hence is not—does not influence savings. There was a paper by Boskins a couple of years ago which was about the first contrary evidence to that. That paper has been replicated in at least two different articles and, depending upon exactly how you define the inflation rate, how you define interest rate, and so on, you can get any results you want. What that tells me is that there is no strong relationship between savings and interest rates, at least over the level of interest rates we have had in this country.

Senator **Bradley**. So, you are saying that, by tinkering with the Tax Code, all we can do is shift savings among different savings instruments, like IRA's or back to tax exempt bonds or to savings accounts, or equity investments, but that it is your conclusion that there is no evidence—no strong evidence—to indicate that that would increase overall personal savings rates in an aggregate.

Mr. **Blume**. That is correct.

Senator **Bradley**. My final question is the following: You say that the best and most useful thing that we could do is to get the Tax Code as neutral as possible, to at least stop distorting allocation of savings and investment. And if we went the income tax route, what would be the best way to get the tax system as neutral as possible in the allocation of capital?

Mr. **Blume**. The best way would be to integrate the corporate tax with the individual tax and then to have a modestly progressive rate structure on the individual tax.

Senator **Bradley**. So, in the system that you have described, but assuming that you didn't integrate the corporate and individual taxes, your argument would be to treat the tax on capital and labor at the same rate.

Mr. **Blume**. Exactly.

Senator **Bradley**. Thank you. I would like to, if I could, ask Mr. Lewis a question. Mr. Lewis, as the head of the Tax Section of the ABA, a lot of your members have advised a lot of clients around the country how to game the tax laws. It is striking to me that you would be here before the committee urging us to dramatically simplify the code and lower the rates. Isn't that against your own interests?

Mr. **Lewis**. Whether it is or not, Senator, believe it or not, the American Bar Association is committed to simplification of the tax laws. We meet as a group, not wearing our clients' collars, and our goal is simplification, whether or not it affects our individual interests.

Senator **Bradley**. You are frequently in the committee and in public meetings that I know I have held. You are frequently viewed as one of those special interest groups, and yet here you are before the committee today urging us to simplify the Tax Code and lower the tax rate for all Americans. Is that not right?

Mr. **Lewis**. That is correct.

Senator **Bradley**. And again, why would you do that?

Mr. **Lewis**. Because we think it is good for the country.

Senator **Bradley**. Thank you.

Senator **Chafee**. Could I ask one question of Mr. Lewis?

The **Chairman**. Sure.

Senator **Chafee**. Mr. Lewis, on pages 3 to 6 of your statement, you touch on the concept of preference for the taxation of capital gains. I have heard it said that the handling of capital gains, whether it is income or whether it is capital gains, is probably the major source of difficulties in the treatment of tax returns and consumes most of the time of tax lawyers. Is that true? Could you set any quantitative judgment on what percentage of time of all the lawyers in dealing with taxation would be involved with capital gains versus income?

Mr. **Lewis**. The capital gains provisions of the Internal Revenue Code are probably the single most complicating factor. When you go through the code and look at volume, they are the most complicating. And I think that we know from our practice that it is one of the areas that we concentrate on very heavily.

Senator **Chafee**. If we eliminated the preferred treatment of capital gains, that would be a major step toward simplification, would it not?

Mr. **Lewis**. It would be a major step toward simplification. I should add, as a qualification, that the section of taxation as a matter of policy does not take positions on issues involving the shift of the tax burden from one major group to another major group, so I cannot appear before you and say take out the favorable rate for capital gains. I say only that it is an immensely complicating factor.

Senator **Chafee**. I wasn't seeking to have you approve it, but I was just trying to get how much time was involved. Thank you, Mr. Chairman.

The **Chairman**. Could I ask Mr. Holcombe maybe the $64 question? If we were to impose a flat rate tax designed to yield the same revenue as the current system, which income classes would gain and which would lose?

Dr. **Holcombe**. According to several studies I have seen, a flat rate tax, given the right personal exemptions at the beginning, would leave the distribution of income roughly unchanged. And here, I am talking about an exemption in the neighborhood of $6,200 or so for a married couple, with an additional $750 per dependent, and then after that, a 19-percent tax rate. A rate like that would leave the distribution of income roughly unchanged after taxes and would replace at least as much revenue as the current Tax Code is raising.

The CHAIRMAN. Now, there are a number of different models running around this morning. Do you have any—is that the FAIR, or the FAST, or what?

Dr. HOLCOMBE. The model that I am using as a model flat rate tax is taken out of a book by a couple of economists, Hall and Rebushka, which I had referenced in my written testimony, and that tax allows——

The CHAIRMAN. That is fairly flat, isn't it?

Dr. HOLCOME. It is very flat. It allows virtually no deductions. It allows a personal exemption. It does not allow home mortgage deduction. It does not allow——

The CHAIRMAN. Let's say you get into these that are a little wrinkled. There are a lot of wrinkled flat taxes running around. Do you still have winners and losers, or does it still come out about the same? Let's say you had the FAST tax—if you haven't studied these, I won't ask you the question. I think Senator Symms has raised a point. Certainly, the flat tax idea has been around here for 55 years according to the Brookings Institution. And it would seem to me if it was that good, somebody would have thought of it and passed it, and maybe we have just been a little slow. But if there are winners and losers, I think we need to find that out, and maybe if you can't address it, I think the proposal you are talking about has been introduced by Senator DeConcini, and maybe others in the Senate. Do you have any observations on either the Bradley-Gephardt or the Kemp-Kasten or the Roth proposal?

Dr. HOLCOMBE. I am not prepared to discuss these particular proposals because I don't know them in detail. I will say that one of the problems in introducing any type of tax reform, as has already been observed, is that every special interest wants to keep their particular benefit, and they are happy to let everybody else's go. And as a result of the lobbying process, none of the special interests seem to lose their benefits. And I have to say, by the way, that I am in favor of the flat rate tax. I am a homeowner, and I would be happy to see the home mortgage deduction go if the uniform flat rate were imposed for everybody, and all the other deductions went with it.

The CHAIRMAN. Three realtors just fainted in the back of the room. [Laughter.]

You have argued that a flat rate tax would be fair to two-earner couples. How do you address that? I mean, to make it neutral again.

Dr. HOLCOMBE. Would you ask the question again, please?

The CHAIRMAN. I think you have indicated that a flat rate tax would be fairer to two-earner couples, where you have two wage earners in the family.

Dr. HOLCOMBE. Oh, I see.

The **Chairman**. Is there any way you can make that neutral? Could you do that by repealing the joint filer provisions of the present law and asking everybody to file separately?

Dr. **Holcombe**. No; I think the flat rate tax is a lot more fair to two-earner couples.

The **Chairman**. Yes, but do they get a better deal than just another taxpayer?

Dr. **Holcombe**. No, the problem right now with two-earner couples is that the second earner's income is added on top of the first earner's income, so if you have a first earner that, say, is up in the 36-percent tax bracket or so, the first dollar earned by the second earner is taxed at the 36-percent rate because the second earner's income is added to the first earner's income at the present time. With a flat rate tax, all income is taxed at the same low rate, and as a result of that, there is no penalty involved in having a second income earner enter the labor market. I think this would be immensely more fair, particularly to women who tend to be the second earners. It would give a bigger incentive to invest in the income earning potential of women.

The **Chairman**. Mr. Lewis, as I understand it, you are not endorsing any particular plan. Is that correct?

Mr. **Lewis**. That is correct.

The **Chairman**. You are just endorsing simplicity?

Mr. **Lewis**. Yes; we are endorsing a study of the system to achieve a less complex income tax.

The **Chairman**. Do you have any advice for the committee on how we can do that based on your experience—and it has been very good and been very helpful to this committee. But how do we do this without our process being undermined by concessions to different groups who have what they view as a very legitimate interest and a reason for exclusion or inclusion?

Mr. **Lewis**. You have a very difficult chore. I think you could best begin by assuming that the new income tax will have no tax preferences at all, and that you then need to counter arguments for particular tax preferences by noting that the preservation of that tax preference will push up rates by so much percentage points or fraction of a point. And that is the bullet you have to bite.

The **Chairman**. That is a problem.

Mr. **Lewis**. Yes.

The **Chairman**. It is a political problem because, once you start down the road of saying we are not going to include mortgage interest or charitable or medical, it is pretty hard to tell the next 10 people that you can't justify their interest. And again, I am not advocating anything. I keep putting that disclaimer in here because somebody will quote me saying I want to eliminate something. But it might bring a return to closed sessions. That might be one way to do it. [Laughter.]

Senator Roth had a question, I think.

Senator **Roth**. Yes; Mr. Blume, I would like to go back to your position on savings. As I understand what you are saying, it is your judgment that based on the studies you have made, there is no strong impact on savings through tax incentives. Is that correct?

Mr. Blume. First of all, let me qualify this. This is based upon my own work and the other work that is available in the literature. There is, first of all, no theoretical reason that higher interest rates induced perhaps by changes of tax rates should lead to higher savings rates. So, it is an empirical question, and the empirical results up until recently were one-sided having no effect. Now, we have some studies which do show a positive effect—at least one that I know of—but that study has been reproduced with slight changes in definition and it goes the opposite way. And what that really tells me as an economist is that there is no strong relationship whichever way it is.

Senator Roth. But there are economists—respected economists—who believe that there is a relationship?

Mr. Blume. I can't speak for other economists.

Senator Roth. Let me ask you this question. Under the current Tax Code, you can deduct interest when you borrow, but you pay taxes on interest resulting from savings. To the extent there is any impact on the individual taxpayer's behavior, wouldn't that be away from savings toward borrowing?

Mr. Blume. You have to distinguish between the overall savings rates and a tax shelter, and it is quite clear that if you can borrow at one interest rate and invest it, say, in an IRA at another, that is a very good tax deal. And there are a lot of people who have been taking advantage of things like that. That does not increase the aggregate savings though.

Senator Roth. Would you agree that the many tax incentives that we have in the code do impact on the individual taxpayer's behavior?

Mr. Blume. It certainly impacts how people channel their investment funds. Definitely.

Senator Roth. At the same time, you don't feel that it would have much of any impact on savings. It just seems to me that to accept your—let me ask you this. What about increasing rates? Would that have an impact on savings?

Mr. Blume. Obviously, if you increase rates substantially enough, it is going to reduce savings. It will reduce all work incentive as a matter of fact. In my testimony, I believe I was very careful to say within the ranges of tax rates we have observed. Clearly, if you make tax rates 100-percent, you are going to get different behavior than we have now.

Senator Roth. I don't want to put words in your mouth, but somewhere at some stage it does have an impact, either toward borrowing or toward savings, as the case may be.

Mr. Blume. Definitely. At some point, with a high enough tax rate, savings and work behavior would be affected.

Senator Roth. Thank you.

The Chairman. Could I just do one little housekeeping thing? Is there any objection to reporting out the nomination of Charles Baker to be Under Secretary of HHS? Without objection.

Senator Symms, and then Senator Danforth.

Senator Symms. I would like to ask a question, Mr. Chairman, and I want to direct to Mr. Holcombe now. I have been working with Senator Roth, and he has got a proposal that is working on the individual side. I am working on one on the small business side, and we have used the Hall-Rabushka as the model for it. And Senator Dole made a comment that the flat rate tax has been around for quite a while, but I would just like to clarify it. My understanding of this is that the Hall-Rabushka proposal is not a tax on capital formation, but is a tax on consumption more or less. Is that correct?

Dr. HOLCOMBE. That is correct.

Senator SYMMS. So, it would be by far—if you are going to have a fair and equitable Tax Code—more fair than the other proposals. Is that correct?

Dr. HOLCOMBE. That is correct. That tax proposal allows for immediate deduction as an expense any capital expenditures and then at the time when the asset might be sold, the sale of the asset is counted as revenue for tax purposes.

Senator SYMMS. Now, what is the difference between that and, say, the Kemp-Kasten proposal?

Dr. HOLCOMBE. I am not familiar enough with that.

Senator SYMMS. How about the Bradley-Gephardt proposal?

Dr. HOLCOMBE. I am not familiar enough with the current proposals to compare it directly.

Senator BRADLEY. Senator Symms, if you would yield, I think if we ask him one or two questions that it might be clear for you.

In this system what is the rate of tax?

Dr. HOLCOMBE. The rate of tax is 19-percent for all income. That is corporate income and personal income.

Senator BRADLEY. And you assert with a 19-percent flat rate that there is no greater benefit going to upper income than middle and lower income people?

Dr. HOLCOMBE. In general, that is going to be true.

Senator SYMMS. You see, Bill, when I made the statement we were using it as a model, we are talking about if it was the ideal model. Now, that is not what is going to pass this Congress because the reality and the——

Senator BRADLEY. No, but just get at his assertion. His assertion is that a flat rate tax does not essentially give it to the upper income and put the greater tax burden on lower and middle income people.

Senator SYMMS. But your——

Senator BRADLEY. The question is what is the base and what is the rate.

Senator SYMMS. Your progressivity comes from the exemptions.

Senator BRADLEY. Well, you can give a standard deduction of $6,000. You know, it doesn't mean that you are not going to have upper income people paying less unless you have a rate that is very high.

The CHAIRMAN. Does the witness agree with this discussion?

Dr. HOLCOMBE. Currently, there are a lot of ways for upper income people to take advantage of the tax laws to avoid paying taxes.

The CHAIRMAN. Yes, there are now.

Dr. HOLCOMBE. State and municipal bonds is a good example, where your income is not subject to tax at all, and these proposals would close those loopholes.

Senator **Symms**. See, the question I am trying to get at here is I would really like to get through my head is what is treated as income. If you receive dividends or interest from savings and investment, in Hall-Rabushka, if I remember correctly, they do not tax a return on capital investment. But does the Kemp-Kasten tax return on capital investment?

Dr. **Holcombe**. I don't know about that.

Senator **Symms**. I think it does. So, there is a fundamental difference here in the approach. So, the Hall-Rabushka is truly a flat tax, where some of the other flat taxes are not really a flat tax.

Dr. **Holcombe**. A lot of the current proposals—I am not familiar with the specific features—but many proposals like the current tax tax savings twice in essence—once when the corporation earns an income, there is a tax paid, and then when it is paid to the individual, the tax is paid again. The Hall-Rabushka proposal eliminates that double taxation on savings.

Senator **Symms**. So, it makes it more efficient.

Dr. **Holcombe**. Right.

Senator **Symms**. It makes the taxing system more efficient to tax only earnings—earned income—but not on—I mean, on what we define as earned income but not tax return on capital investment, so it would encourage and enhance efficient investment in the economy.

Dr. **Holcombe**. That is right.

Senator **Symms**. That is the point of it.

Dr. **Holcombe**. Right.

Senator **Symms**. OK. Thank you, Mr. Chairman.

The **Chairman**. Do you have a question?

Senator **Danforth**. Mr. Blume, a consumption tax would encourage savings, wouldn't it?

Mr. **Blume**. I would not think that we would see great increases in savings rates with a consumption tax. Currently people have estimated that the capital gains tax—about 5 percent—of taking into account the possibility of passing on assets to heirs through inheritance, and going from 5 to 0 on that type of income I don't feel is going to have much of an effect. And with investment income, typically savings accounts and so on which tend to be held by lower income families currently—moderate income families—they are not paying much tax on them now anyhow, but I don't think that that is going to cause a great increase in the savings rate.

Senator **Danforth**. Is your testimony that within reason—I mean if you taxed 100 percent, nobody would save anything—but is your testimony that within reason there is really nothing that we can do that would affect savings one way or another?

Mr. **Blume**. Within reason, I think that is probably correct.

Senator **Danforth**. Thank you.

The **Chairman**. We want to thank you very much, and we are going to be reviewing your testimony, and we may ask that you return if you think of anything else that might be helpful to us. We thank you very much for being here.

Mr. **Blume**. Thank you.

The **Chairman**. We next have a panel of Dr. Emil Sunley, director of tax analysis, Deloitte, Haskins & Sells, Ernie Christian, Washington, DC, Jerome Kurtz, former Commissioner of IRS, and

Charlie Walker, chairman of the American Council for Capital Formation.

Welcome, all you experts here this morning. And again, if we can have—and I know we will have with this outstanding group—cooperation of the witnesses in leaving us some time for questions. We think we have a chance to develop some areas as we did with the last panel. We will be happy to start with Dr. Sunley. Every one of these gentlemen has been before this committee a number of times. We appreciate your being here today. We will start now with Dr. Sunley.

STATEMENT OF EMIL M. SUNLEY, DIRECTOR, TAX ANALYSIS, DELOITTE, HASKINS & SELLS, WASHINGTON, DC

Dr. SUNLEY. Thank you, Senator Dole. Senator Grassley expressed some concern about what you would do with all the lawyers if you ever had fundamental tax reform, and I should inform the committee that it is my understanding that NIH has been using lawyers in some of their experiments instead of rats. [Laughter.]

They have found in Washington that there are more lawyers and that experimenters are less likely to become fond of one of them. [Laughter.]

My message today, Mr. Chairman, comes in three parts. First to close the gap between spending and revenue will require reductions in both defense and domestic spending and an increase in taxes. The required tax increase probably will be about 2 percent of gross national product. This could be achieved using existing Federal revenue sources inasmuch as Federal income, estate and gift and excise taxes today are almost 2 percentage points lower as a share of gross national product as compared to 1974.

My second point is that when considering tax reform three issues should be separated; namely, what should be the tax base, how much revenue should be raised, and how should the tax burden be distributed? The pamphlet prepared by the Joint Committee on Taxation separates these three issues very well. According to their sponsors, the Bradley-Gephardt and the Kemp-Kasten proposals for broad-based income taxes are designed to be revenue-neutral, at least before the enactment of the Deficit Reduction Act of 1984. These proposals are also designed to raise the same amount of revenue from each income class as under current law. Thus, by focusing on what should be the tax base these proposals separate the issue of tax base from the other two; namely, how much revenue should we raise and what should be the distribution of that tax burden.

My third point is that before various deductions, credits, exemptions, and exclusions are repealed, Congress should evaluate each one separately to determine whether it should be repealed, modified, or replaced with a direct expenditure program. The decisions inevitably will involve tradeoffs between equity and efficiency.

If I may draw on my experience from the Treasury Department, I find that too often we may have opposed or supported certain tax provisions or tax proposals on the grounds that they were "good tax policy." But maybe what we should have considered whether this was good expenditure policy. Did we really want to subsidize this kind of activity? Was there a better way to undertake that kind of subsidy program?

I conclude my prepared testimony with brief case studies of tax shelters and minimum taxes to illustrate some of the tradeoffs between equity and efficiency. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[Dr. Sunley's prepared written statement follows:]

STATEMENT OF
EMIL M. SUNLEY
DELOITTE HASKINS & SELLS
ON
SUBSTANTIVE TAX PROPOSALS
BEFORE THE SENATE FINANCE COMMITTEE
AUGUST 7, 1984

I am Emil M. Sunley, Director of Tax Analysis in the National Affairs Office of Deloitte Haskins & Sells, an international accounting firm. I am most pleased to appear before you today to discuss substantive tax proposals.

My message today comes in three parts. First, to close the gap between spending and revenues will require reductions in both defense and domestic spending and an increase in taxes. The required tax increase, probably equal to about 2 percent of GNP, could be achieved using existing federal revenue sources inasmuch as federal income, estate and gift, and excise taxes are today almost two percentage points lower as a share of GNP as compared to 1974. Second, when considering tax reform, three issues should be separated; namely, what should be the tax base, how much revenue should be raised, and how should the burden be distributed? I focus primarily on the choice between the income and the consumption tax base. Third, before various deductions, credits, exemptions and exclusions are repealed, Congress should evaluate each one separately to determine whether it should be repealed, modified, or replaced with a direct expenditure program. There inevitably will be trade-offs between equity and efficiency. I conclude with brief case studies of tax shelters and minimum taxes to illustrate some of these trade-offs.

The Continuing Gap Between Spendings and Revenues

The gap between federal spendings and revenues is now running at $170 billion, or just under 5 percent of gross national product (GNP), with spending running at 23.9 percent of GNP and revenues at 19.1 percent of GNP. According to the most recent estimates of the Congressional Budget Office, the federal deficit as a share of GNP is expected to remain between 4.5 and 5 percent of GNP over the next several years. Even assuming continued real growth, the deficits will incease to $263 billion by 1989.

My testimony today is premised on the assumption that the gap between federal spending and revenue cannot be closed by reducing spending alone. It is likely that federal taxes will have to rise by at least 2 to 2.5 percent of GNP.

Is a Major New Revenue Source Needed?

If it is assumed that the gap between federal spending and revenue is closed half by reducing spending and half by increasing income taxes, corporate and individual income taxes together would have to increase by nearly 2.5 percent of GNP. Given that income taxes are now equal to 10 percent of GNP, income taxes would have to rise by 25 percent -- equivalent to a 25 percent surcharge. To accomplish this by base broadening would be a Herculean task equivalent to cleaning the Augean stables. Many observers would conclude that a major new revenue source is needed.

Though the federal deficit should be reduced, it is not clear that it needs to be eliminated over the next several years. An interim goal might be to reduce the federal deficit in fiscal 1987 to about 1 percent of GNP, by reducing spending by 2 percent of GNP and increasing revenues by 2 percent of GNP.

Is this an impossible task? Over the last three years Congress has reduced federal revenues by over 2 percent of GNP from a high of 20.8 percent of GNP in fiscal 1981 to 18.7 percent of GNP this year. All that is necessary to meet the interim goal is now to increase revenues by 2 percent of GNP.

But it is not necessary to go back to where we were in 1981. Instead, we could go back to 1974, before Congress enacted The Tax Reduction Act of 1975, The Tax Reform Act of 1976, The Tax Reduction and Simplification Act of 1977, The Revenue Act of 1978, The Economic Recovery Tax Act of 1981, The Tax Equity and Fiscal Responsibility Act of 1982, and The Deficit Reduction Act of 1984. At that time federal taxes were 19.1 percent of GNP compared to 18.7 percent in 1984 (See Table 1). The major difference between 1974 and 1984 is the sharp increase in social insurance taxes from 5.4 to 6.7 percent of GNP. Federal income, estate and gift, and excise taxes were 13.0 percent of GNP in 1974, almost 2 percentage points higher than the 11.3 percent share for the same taxes in 1984. Federal revenues can be increased by almost 2 percent of GNP simply by restoring income, estate and gift, and excise taxes to their 1974 levels as a share of GNP.

Value-Added Tax

The major alternative to increasing revenues from existing federal revenue sources is a value-added tax. A value-added tax is a multi-stage tax on consumer goods and services. Unlike a retail sales tax, it is collected at each stage in the production and distribution process.

Let me suggest, without supporting evidence, that it is probably not worthwhile to impose a VAT to raise revenues equal to only 2 percent of GNP. A more likely scenario, I believe, is a VAT with a 10 percent tax rate. Given the usual exemptions and exceptions, this tax would increase revenues by about 3.4 percent of GNP.[1/] Before one signs on to a VAT, one will want to have some understanding of how the additional revenues will be used. Presumably, they will go toward buying off the states and reducing regressivity. But after that, will they be used to reduce the deficit or to increase spending. How the revenues will be used is the crucial questions to be answered be endorsing a major new lever for the government to pull.

Three Issues

In his last State of the Union address, President Reagan called on the Treasury Department to provide recommendations

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[1/] Personal consumption expenditures are about 65 percent of GNP. With exemption for direct and imputed rents, medical care and drugs, private education, charitable activities, and state and local governments, the base of a VAT might equal 45 percent of GNP. The gross revenue yield of a 10-percent VAT would then be 4.5 percent of GNP. The VAT, however, would reduce the base for the income tax: someone's income, as a share of GNP, must be lower, if indirect business taxes have gone up. Assuming that the marginal income tax rate on an additional dollar of GNP is 25 percent, the 10-percent VAT would net increased revenues of 3.4 percent.

for tax reform by late this year. Treasury was directed to study a flat rate tax, a tax on consumed income, a national sales tax and a value-added tax. The Deficit Reduction Act of 1984 instructs the Treasury to study alternatives for replacing the federal income tax -- the individual income tax alone and both the individual and corporate income taxes -- with an alternative tax system and to report to Congress by the end of the year. This report is to include a study of tax shelters.

The Treasury has indicated that it is conducting its studies of tax alternatives in a revenue neutral context. Though I believe that additional tax revenues are needed, this approach is appropriate because it permits one to separate three issues.

(1) What should be the tax base?

(2) How much tax revenue should be raised?

(3) How should the tax burden be distributed across families and individuals?

All too often these three issues are intermingled. For example, the Treasury Department will often oppose a new tax deduction on the grounds that it will cost too much revenue or the tax benefits from the deduction will be skewed to those families and individuals with high incomes. The crucial issue -- what should be the tax base -- is often ignored. In theory, at least, if the new tax deduction is adopted, marginal tax rates can be adjusted to achieve whatever revenue target and whatever desired distribution of tax burdens across income classes the Treasury desires. In conducting its study of tax alternatives in a revenue neutral context, the Treasury is focusing on the crucial issue of reforming the tax base. Questions of how much revenue to raise and from whom to raise it can be addressed separately.

The Income or Consumption Tax Base

In modern times income and wealth generally have been viewed as the most appropriate tax base because they are the best measures of ability to pay. In recent years there has been increasing academic interest in consumption as a more equitable tax base.

Proponents of the consumption tax base argue that the income base is less fair because it results in a double taxation of savings -- both the amount of savings and the return on savings are taxed. As a result, the income tax biases the choice between future and present consumption. Those who favor the income tax base counter by arguing that saving is a personal decision about the use of income it; does not diminish the saver's capacity to bear taxation.

Proponents of the consumption tax base maintain that the whole lifetime of circumstances should be taken into account in choosing the optimal tax base. The equity principle of equal treatment of equals would only be satisfied if individuals who have the same lifetime capacity to consume, discounted to present value, pay equal lifetime taxes, again measured in present value terms. Under this approach, a consumption tax would be based on all money income a person receives over his or her entire lifetime, including inheritances and gifts; or alternatively on spending over his or her entire lifetime, including bequests and gifts made. An income tax does not meet this criterion for fairness because the present value of the tax liabilities will be greater if taxpayers save for later consumption. Though defining equal treatment of equals on the base of an entire lifetime of circumstances is quite elegant, it is not at all clear that taxpayers make economic decisions taking into account all resources available to them for consumption over their lifetime.

A major argument in favor of a consumption tax is that it would increase the net return on saving. Recent empirical works suggest that increasing the net return on saving will increase the amount of savings in the economy. Even if saving did not increase, many economists favor the consumption tax base because it would improve allocative efficiency inasmuch as all forms of saving would be treated alike.

The debate over the choice between a broad-based income or a broad-based consumption tax may be mainly academic. The practical choice is not between these two alternatives. If the income tax base is chosen as the appropriate measure of ability to pay, there will continue to be a significant departure from the ideal tax base. Similarly, if consumption is chosen as the ideal measure of ability to pay, there will also be significant departures from this ideal tax base. The realistic choice is between an income tax that excludes major portions of income such as unrealized gains and losses and a consumption tax that excludes major types of consumption such as housing and food.

Both a broad-based income and a broad-based consumption tax could raise the same amount of revenue. The marginal tax rates under the broad-based consumption tax would have to be somewhat higher than under the broad-based income tax because the consumption tax base is somewhat smaller inasmuch as saving is excluded from the base. Moreover, though transaction-based consumption taxes -- the retail sales tax and the value-added tax -- are regressive relative to income, a consumption tax can be made as progressive as an income tax. The progressive expenditure tax outlined in a Treasury study, Blueprints for Basic Tax Reform, released in early 1977, would have permitted much lower marginal tax rates, but nevertheless would have left undisturbed the distribution of the tax burden across income or consumption classes. A progressive consumption tax, sometimes called a cash flow tax or a tax on consumed income is essentially an income tax with a super IRA account, but no deduction for interest paid.

Progressivity

How progressive should the tax system be? Economists have very little to say about how this. They will tell you, however, that progressive taxes -- taxes where the average effective tax rates rise with income -- cause greater economic distortions. But progressive taxes also are viewed by many as more equitable. It is generally perceived that those with higher incomes have a greater ability to pay taxes than those with lower incomes and those with higher incomes can pay a greater share of their income in taxes than those with lower incomes. This perception that the tax system should be progressive gives very little guidance as to just how progressive the tax system should be. Clearly it is not necessary for every tax in the government's tax arsenal to be progressive. The issue is whether the overall tax burden, once all taxes are taken into account, is distributed in a fair manner.

Though the individual income tax is less progressive than the nominal rate schedule would suggest, the tax remains a progressive tax. It is probably a more progressive tax than the average "man on the street" believes. Going to a pure flat rate tax, as some have suggested, would significantly reduce the progressivity of the individual income tax. If the same amount of revenue is to be raised, the tax liabilities of low-income families would be increased while that of high-income families would be reduced.

Ultimately Congress must decide how progressive the tax system should be. It is my experience that Congress can work its will in this area. Beginning with The Tax Reform Act of 1969 and through most of the 1970s, Congress made the individual income tax more progressive primarily by sharply increasing the standard deduction and reducing some of the tax preferences used by high-income families. The 1981 legislation redressed the balance by providing somewhat greater tax reductions for high-income families, particularly when measured as a percentage of after-tax income. The standard deduction and the personal exemption were not increased.

As Congress considers proposals for broad-based income or broad-based consumption taxes Congress will want to adjust the marginal tax rates to achieve the degree of progressivity it deems appropriate. Though some may prefer a more progressive tax system and others a less progressive tax system, the choice as to how progressive the tax system should be is essentially a political one involving trade-offs between economic efficiency and equity.

Proposals for Broad-Based Taxes

There are a number of proposals before Congress for either a broad-based income or broad-based consumption tax. The broad-based income tax proposals include the Bradley-Gephardt Fair Tax, the Kemp-Kasten Fast Tax, and the Quayle Self Tax. Congressman Heftel and Senator DeConcini have proposals for broad-based consumption taxes. Each of these proposals would eliminate many deductions, credits, exclusions and exemptions and would provide much lower marginal tax rates. According to their sponsors, each of the proposals is designed to raise about the same amount of revenue as under current federal law, at least before enactment of The Deficit Reduction Act of 1984. The broad-based income tax proposals are designed to raise approximately the same amount of revenue from each income class as under current law. I believe the proposals for broad-based income or broad-based consumption taxes provide a road map for how the tax system should evolve. When it is appropriate to reduce taxes, the reduction should take the form of reductions in marginal tax rates. When revenues must be increased, which is the situation today, deductions, credits, exemptions and exclusions that are no longer needed or of a lower priority should be eliminated or reduced.

None of the proposals for a broad-based income or broad-based consumption tax should be adopted on a simple up or down vote. Though a very strong case can be made for moving to a tax with a broader base and lower marginal rate, it must be recognized that to move from here to there requires the repeal of many tax preferences. Each of these tax preferences must be examined separately. The crucial questions are whether:

- the original purpose of the tax preference is still valid

- the tax system is the most efficient mechanism for delivering the government subsidy

- the tax preference should be replaced by a direct spending program.

Case Study of Tax Shelters

In every major tax act, beginning with The Tax Reform Act of 1969, Congress has looked at tax shelters, those investments which throw off tax losses that can be used to shelter other income from taxation. Congress has cut back on some of the underlying tax preferences that give rise to tax shelters, imposed a minimum tax, added at-risk rules to the Code, and strengthened compliance and reporting requirements. Even though marginal tax rates have been reduced from 70 to 50 percent, tax shelters remain a growth industry. What to do about tax shelters provides a case study of the problems of going to a broad-based income tax.

First, let us distinguish abusive shelters from legitimate ones. By abusive shelters I mean those tax shelters that have little or no economic substance. One knows a promoter is peddling an abusive shelter when one asks him what kind of asset the partnership will have left at the end of 10 years and he simply hangs up the telephone. Tax professionals, the Internal Revenue Service, and the Congress recognize that abusive shelters erode the integrity of our tax system. A recent court opinion concluded:

> "The long and the short of it all is that the parties demeaned themselves in entering so dishonest a venture, unquestionably structured to garner for each of the taxpayers tax advantages to which they were not entitled and devoid of any realistic business purpose. In this case we confront only risk-takers who believed they proceeded on a no-loss path; if they got away with it, well and good from their misguided point of view, and, if they did not, they would be no worse off than had they never sought the unjustified benefits in the first place. We refrain from any expression of opinion as to whether the taxpayers have exposed themselves to the risk of criminal prosecution. However, even assuming that perhaps they have not, they, by their conduct, nevertheless reveal a malaise which a healthy United States of America cannot sanction. It is a frightening prospect when our wealthy citizens, those in the highest income tax brackets, seek to take indefensible advantage of the country and their fellow citizens, especially those who have far less from which to meet their tax responsibilities." (Murnaghan, J.), Barnard v. Commissioner, No. 83-1777 (4th Cir. 4/5/84).

The Deficit Reduction Act of 1984 gives the Internal Revenue Service new weapons to deal with abusive tax shelters. It is not clear whether these weapons will be sufficient. But ultimately Congress should be able to enact rules that will put a fence around abusive shelters, forcing taxpayers who want to shelter income from taxation to invest in legitimate shelters or commit fraud.

Even if all abusive tax shelters are eliminated, the remaining tax shelters would still pose a significant public policy problem. On the one hand, Congress wants to encourage investment in real estate, low income housing, historic rehabilitation, research and development, and oil and gas drilling. The tax savings from artificial tax deductions and tax credits are a significant portion of the economic return on these investments. To repeal the tax preferences that give rise to the tax shelters would have a major impact on these industries. On the other hand, we must recognize that the specter of high income people sheltering income from tax may erode the integrity of our tax system.

What are the choices? If the primary concern is tax shelters undermining the integrity of the tax system Congress could put a limit on the ability of taxpayers to use artificial deductions to shelter other income. The Nixon Administration made such a proposal in 1974. This approach will necessarily blunt the incentive effect of the underlying tax preferences. If the primary concern is fostering targeted industries, then Congress must accept that the integrity of the tax system may be undermined. In short, there is a trade-off between the efficiency of the tax incentives and the perceived equity of the tax system. This trade-off needs to be carefully evaluated as Congress considers proposals to move to a broad-based income tax.

Minimum Tax

The original minimum tax proposed at the end of the Johnson Administration was an alternative tax with progressive rates that would have applied only to individuals. It was argued that whatever may be the merits of various tax preferences, every individual with substantial income should pay a minimum tax toward the cost of government. Congress enacted in 1969 a 10 percent add-on minimum tax applicable to both individuals and corporations. The rate was increased to 15 percent in the 1976 legislation. In 1978 individuals with net long-term capital gains and excess itemized deductions were made subject to a separate alternative minimum tax with progressive rates up to 25 percent. The 1981 Act reduced the top rate to 20 percent.

The alternative corporate minimum tax proposed by President Reagan in 1982 was seriously flawed. The major impact of the proposal was to disallow investment tax credits and to disallow net operating loss deductions. It would be possible to design a fair alternative corporate minimum tax. Complex rules, however, would be required to closely coordinate this tax with the regular income tax.

Any minimum tax dampens the incentive effects of tax preferences. Congress, by enacting a minimum tax, in effect is saying that if a business engages only a little in activities encouraged by tax subsidies, no minimum tax is imposed; but if the business is good at these activities and specializes in them, it will have to pay the minimum tax, putting it at a competitive disadvantage.

Even though minimum tax has reduced the effectiveness of tax incentives, there is a strong justification for a minimum tax on individuals because equity considerations are also important. It is generally agreed that individuals with large economic incomes should pay a fair share of the tax burden. If they do not, the perceived fairness of the tax system is eroded, and tax compliance is undermined.

The case of a minimum tax on corporations is much less persuasive. When the corporate veil is pierced, many owners of large corporations do not have large economic incomes. Also, the major preference items subject to the corporate minimum tax are found in only a few industries. Whether the tax structures of these industries should be altered is a question that should be addressed separately. Presumably these questions are being addressed in the Treasury studies of a broad-based income and consumption taxes.

TABLE 1

FEDERAL TAXES AND THE DEFICIT AS A SHARE OF GNP 1974-1987

	1974	1980	1984	1987
Personal income taxes	8.6	9.5	8.4	8.9
Corporate income taxes	2.8	2.5	1.7	1.9
Estate and gift taxes	0.4	0.2	0.2	0.1
Excise taxes	1.2	0.9	1.0	0.8
Subtotal	13.0	13.1	11.3	11.7
Social insurance taxes	5.4	6.1	6.7	6.8
Other receipts	0.6	0.8	0.8	0.7
Total	19.1	20.1	18.7	19.2

Source: For 1974, Budget of the United States Government, Fiscal Year 1984, p. 9-40 and p. 9-53; for 1980, Budget of the U.S. Government Fiscal Year 1985; p. 9-46 and p. 9-60; for other years, Congressional Budget Office, The Economic and Budget Outlook: An Update (August 1984), p. 57.

STATEMENT OF ERNEST S. CHRISTIAN, JR., ESQ., WASHINGTON, DC

Mr. CHRISTIAN. Thank you, Mr. Chairman. As a theoretical matter, a broader based, low-rate tax is probably preferable. But given the fact that we do not have that system now and would have to shift to it, we ask whether we really do want to drastically lower the marginal rates of tax on individuals. One could speculate that a 20-percent tax on individuals—if that was the highest rate—might in fact virtually destroy the private pension and retirement system in this country. That system is largely a creature of high nominal rates of tax. We must also ask about savings incentives. If the nominal rates of tax are very low—such as 15 or 20 percent—those rates will not very much influence behavior toward savings. Have in mind that we are not talking about a tax cut. Merely because rates are lower and the base is broader does not mean that the average person is going to have more money in his pocket to spend or to save. When we engage in severe marginal rate reduction, three is a also significant retroactive effect, and a devaluation of many existing assets. All existing tax-exempt bonds—not just those issued in the future but those outstanding—might be virtually worthless if we had a 20-percent tax rate.

On the other hand, high marginal rates are the reason that we have for so long engaged in the process of eroding the tax base. Part of that erosion has been to take more and more people off the tax rolls. I wonder whether we can continue to take more people off the tax rolls and end up with a society where we have a majority of voters who do not pay any income taxes voting to impose taxes on a minority of voters.

I also wonder whether our income tax ought to be both our primary source of revenue and our only cyclical and countercyclical device. In 1984, when for cyclical budgetary reasons we have desired to raise $40 or $50 billion, perhaps it would have been much better had we had some other tax, in addition to the income tax, that we could have raised without having to spend 1,300 pages tearing apart the Federal income tax. Such broad and detailed changes do have economic costs and do destablize business conduct and personal conduct.

Ultimately one gets down to talking about base broadening and about tax expenditures, I would merely conclude by suggesting that there are two approaches with respect to tax expenditures. The committee is not confined to merely throwing them all out, or picking and choosing between them on a "sheep and goats" basis. Instead, there is a theory and a mechanism by which the committee can retain tax expenditures—and merely cut all of them proportionally back a little bit. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Mr. Kurtz?

[Mr. Christian's written prepared statement follows:]

STATEMENT

OF

ERNEST S. CHRISTIAN, JR.

BEFORE

THE

SENATE COMMITTEE ON FINANCE

RE: FUNDAMENTAL TAX REFORM

August 7, 1984

Thank you, Mr. Chairman. I appreciate the opportunity to speak to the Committee about fundamental tax reform. My testimony is directed (i) toward what I believe to be some fundamental questions the Committee must be cognizant of in approaching fundamental tax reform, and (ii) toward what I believe to be some fundamental principles and points the Committee should have

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* Mr. Christian was formerly Deputy Assistant Secretary of the Treasury (Tax Policy). These ideas are solely the individual view of the witness, and not those of any firm or organization with which the witness may directly or indirectly be associated.

in mind in approaching fundamental tax reform. In formulating these questions, principles and points for the Committee's consideration, I have been conscious of the fact that fundamental tax reform may have to be carried out in the context of historically high deficits. It is possible large additional amounts of revenue may be raised at the same time that we attempt to reform the tax system. Therefore, the task must be undertaken with the greatest of care and skill.

Fundamental Questions

1. Do we really want drastically to reduce the marginal rates of tax for individuals? Assuredly, a broad based-low rate tax is preferable to the narrow base-high rate tax we have now. But there are costs associated with that. Would drastic rate reduction destroy the private pension and retirement system? What about savings incentives? What about the severe retroactive effect of rate reduction?

2. On the other hand, high nominal rates are the source of the enormous base erosion that afflicts the present tax system. Do we really want to continue to take more and more people effectively off the tax rolls? Should a majority of voters impose income taxes

on a minority without any cost to themselves? Given the fact that government spends as well as taxes, do we want a majority of "net takers" and a minority of "net payers"?

3. Do we want to continue to rely on the income tax both as a principal source of revenue and as our only cyclical and counter-cyclical device? Our present income tax has a powerful regulatory effect on both personal and business behavior. There is a "cost" associated with tearing apart and putting back together that complex structure every year or two as we now seem to do. Instead, would it not be better to have some supplemental revenue source that could be easily decreased or decreased to meet cyclical revenue needs?

4. Do we really want greatly to alter the present distribution of the tax burden? For example, in the corporate tax there are significant differences between the highest and lowest so-called effective tax rates paid by different companies. Tax reform might narrow those differences somewhat, but cannot and should not eliminate them. By and large those differences are fundamental to the measurement of income when varying levels of fixed capital investment are required in

different lines of business. To raise the lowest effective rates up to the level of the highest effective rates would require the imposition of confiscatory taxes on capital. Consistent with the pattern of history, we should recognize that as businesses become increasingly capital intensive, the productivity of labor will increase.

Basic Principles And Points

1. To the extent that it is necessary significantly to increase taxes to address the temporary deficit problem, care should be taken not to build in structural changes that may in the long-term produce too much tax revenue. E.g., merely because taxes may temporarily be increased to, say, 22% of GNP, does not mean that we want taxes always to extract that large a percentage of GNP. Thus, deficit-reduction tax changes that produce a declining path of revenues between now and 1990 may be preferable.

2. In a deficit-reduction context, the larger the tax increase in the early years of any 3 to 5 year budget cycle, the smaller the total tax increase that will be necessary to reach any given long-term deficit-reduction target. That phenomenon arises because of larger interest savings on federal debt.

3. True tax reform that eliminated the distortions that presently result from high nominal rates and a randomly eroded base could have a sufficiently salutory effect to offset all or part of the "drag" on productivity that would result from an aggregate increase in tax collections as a percentage of GNP. In this regard, reform of the individual and corporate income tax system might raise no additional net revenues. Increased revenues for deficit reduction purposes might come from some new tax mechanisms.

4. A time such as 1985 when the focus for reform and the needs for revenue may be coming together to produce some "watershed" change in the direction of tax policy, provides opportunities but also presents a risk.

a. We should resist the temptation to rely too heavily on one single tax. Instead, any new revenues can best be provided from a variety of taxes.

b. On the other hand, we should avoid too dramatic a change in the introduction of too much in the way of new tax mechanisms. The shock effect of a large increase in revenue collection and a new system introduced all at once might be unnecessarily disruptive.

5. Proposals to supplement income tax revenues usually center around a value-added tax or some other form of transaction-type consumption tax. Many such proposals have merit. However, the political question of progressivity vs. regressivity immediately dominates the debate. The danger is that the desire to avoid regressivity will inevitably result in a two-track tax system and a two-track society; those who only pay the value-added tax and those who pay both the value-added tax and the income tax. The danger of having only a relatively small number of income tax payers have already been alluded to. The further problem is the possibility of a substantial increase in the progressivity of our overall tax system.

6. Our tax system is probably already more progressive than it should be when we take into account the net distributional effects of government taxes and government spending.

a. Too often progressivity focuses solely on the progression of rates from the lowest rate to the highest rate.

b. We must also focus on the number of people off the tax rolls at the so-called lower end of the income scale.

c. Perhaps even more important, we should focus on the vast disparities in so-called effective tax rates among people within the same adjusted gross income class.

Apart from base erosion, the most significant aspect of progressivity is not the rates of tax, but rather is the width of the brackets. The question of when (at what amount of income) a person hits a high tax rate is basically far more important than how high the rates are. Fundamental tax reform should consider substantial bracket widening instead of bracket compression as some broad based-low rate and flat rate proposals seem to suggest.

7. Because nominal rates for both individuals and corporations are already high, ultimately we will come down to so-called base broadening if the tax system is to be reformed and revenues are to be increased at the same time. Leaving aside the possibility of supplementing revenue by a partial shift to a consumption base, and looking solely at an income base, in the final analysis we are talking about "tax expenditures." There are several approaches to "tax expenditures."

a. The traditional approach (thought by many to be the only approach) is to look at the list, and through a "sheep and goats" process totally retain some tax expenditures and totally discard others.

b. Another approach is to recognize that all tax expenditures have some degree of merit and some constituency. Instead of picking and choosing, all tax expenditures can be retained but all tax expenditures can be cut back slightly.

Another question in evaluating so-called "tax expenditures" is whether each dollar of each expenditure is to be treated the same in the hands of every taxpayer; or whether any particular tax expenditure is to be treated differently in the hands of different taxpayers depending on how much tax that person pays or does not pay. Both logic and experience suggest that the former more even-handed approach is preferable.

8. A final point related to base broadening has to do with the role of our tax system in a world economy. Traditionally, tax reform has focused on whether too little of the foreign source income of American companies is being included in the U.S. tax base. Today, that is not a particularly useful or pertinent inquiry in my opinion. Rather, "tax reform" should be focusing on whether the U.S. tax base is being too much eroded by goods manufactured abroad and sold in the U.S. economy. I am not talking about protectionism.

I am merely pointing out that imports are an increasing portion of sales in the U.S., that these sales contribute little to U.S. tax collections, and that insofar as business taxes are concerned we impose taxes primarily on "value-added" in the U.S.

Conclusion

Again, I thank the Committee for its time and attention. I recognize that because of the shortness of time allotted, my testimony has posed more questions than answers. Thus, I shall be happy to respond to any questions the Committee may have and to file any supplemental written statement for the record as shall be helpful.

STATEMENT OF HON. JEROME S. KURTZ, FORMER COMMISSIONER, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Mr. KURTZ. Let me summarize just a few points I make in my statement that I submitted for the record.

The CHAIRMAN. I would say that all the statements will be made part of the record.

Mr. KURTZ. Thank you. These hearings attest to the fact that we all recognize the tax system has severe problems today. It is much too complicated, widely regarded as unfair, rates are too high, it is riddled with loopholes, and as a result, compliance is a serious problem. And almost all of the proposals that have been put forth here have one thing in common—simplification. Simplification requires base broadening, the elimination of most so-called tax expenditures, and reduction of the importance of those that remain. As a consequence of having a much broader base, we would be in the position of being able to have considerably lower rates.

Lower rates obviously would be a help in compliance. It would make taxes less an item to be considered in arranging one's conduct, and lower rates themselves, it seems, would substantially ease the pressure on future tax expenditures because there is less to be gained by gaining an exception. Let me say that simplification, however does not involve two things. It does not involve flat rates in place of progressive rates, and it does not require going from an income tax to a consumption tax. These are completely separate issues. While one may argue that there is some complexity that goes with progressive rates, it is very minor. The issue of progressivity versus flat rates is an issue of social philosophy. It is a question of whom we think ought to pay how much tax. Whatever complexity goes with progressive rates is minor compared to the seriousness of a decision to go to a flat rate tax. People in this country overwhelmingly believe that a progressive rate tax is fair, that people who are more affluent ought to pay not only more tax, but proportionately more tax and that those who are unable to pay anything shouldn't pay anything.

The consumption tax in its effect is exactly the same as a tax on wages alone. I submit to you that this country will not tolerate a tax on wages alone; a tax which completely exempts income from interest, from dividends, from rents, from capital, and puts the entire tax burden on wage earners. And it only compounds that inequity to suggest imposing such a tax at a flat rate.

It may be that consumption taxes would be some encouragement to savings. I think from listening to the economists and reading the economic literature that that case has not been made or, if it has been made, it is that the differences are very minor compared to the tax relief, and it seems to me we have to consider very seriously the implications of the equity of the system in changing. People comply with the tax laws only if they have some reasonable belief that the tax system is fair.

If we create a system that is widely viewed as unfair, I think the compliance problems would be insurmountable. Thank you.

The CHAIRMAN. Thank you. Mr. Walker?

[Mr. Kurtz's prepared written statement follows:]

UNITED STATES SENATE COMMITTEE ON FINANCE
HEARING ON MAJOR TAX REFORM
STATEMENT OF JEROME KURTZ
AUGUST 7, 1984

Mr. Chairman and Members of the Committee:

My name is Jerome Kurtz. I am a lawyer in private practice in Washington, D.C. From 1977 to late 1980 I was Commissioner of Internal Revenue. I am pleased to appear today at your invitation to participate in these very important hearings.

Few would quarrel with the observation that our income tax has severe problems. It is too complicated. It is widely regarded as unfair. Rates are too high. It is riddled with loopholes and compliance is falling.

These hearings are a recognition of the severity of these problems. The number and variety of proposals for comprehensive tax reform that have been developed in recent years further attest to the breadth and depth of concern about the continuing ability of our tax system to finance the needs of government. While many different proposals have been put forward, they may all be described as variations of a few themes.

Since it is widely recognized that the complexity of the present system is at the heart of our tax problems, all proposals for reform would sharply curtail the number and size of various deductions and credits now contained in the law. Such "base broadening" would, in addition to simplifying, permit lower rates, since the amounts subject to tax would increase. Lower marginal rates are obviously welcome, reducing as they would, the importance of tax in economic decision making.

While in many circumstances complexity is a price we pay for equity, this notion is largely inapplicable to our income tax. Tax simplification will improve equity. This is because most of the complexity in our tax law has not to do with measuring income as a basis for determining taxpaying capacity -- the proper function of a tax base -- but rather with encouraging particular activities.

Our tax laws now contain over 100 special provisions -- called tax expenditures -- which reduce taxes through exclusions, deductions and credits having little or nothing to do with a taxpayer's real income and ability to pay tax. These special provisions are called tax expenditures because they are carrying out, through tax relief, programs which more traditionally, and more propertly, should be considered spending programs.

Using the tax system to further specific economic and social programs has seemed attractive because tax expenditures appear easier to administer than direct spending programs and provide an almost complete absence of red tape. Moreover, they do not appear in the budget.

We have, I hope, come to realize that ease of administration and absence of red tape has only meant misdirected programs and waste. And I assume we all now realize that tax expenditures cost the same as comparable direct programs. This has become painfully apparent as we have seen our tax base shrink at the same time as the pressure for greater tax expenditures has increased. A cycle has ensued in which the erosion of the tax base due to the granting of special tax relief has led to higher marginal rates which in turn has only increased the demand for more special relief.

What was not well recognized as the number and size of tax expenditures grew was the cumulative effect they were having on the tax system.

Tax expenditures account for over 40% of the potential individual income tax base and over 60% of the potential corporate tax base. That is an indication of the amount of additional tax that would be collected if there were no tax expenditures in our law. No one suggests that this additional revenue be collected. The relevance of the figure is that if there were no tax expenditures, rates could be reduced by amounts approaching 40% for individuals and the same revenue would be collected. If this were done, not only would the tax law be far simpler, but the tax burden would be shared more equitably and rates would be much lower. There would be greater horizontal equity, i.e., those with similar amounts of income and thus similar tax paying capacity would pay similar taxes. And there would be greater vertical equity; those with greater real incomes would pay higher taxes. The situation of the oil baron or real estate investor paying less tax than the factory worker would be no more.

If most tax expenditures were to be eliminated -- and that is the underlying assumption of broad-based or simplified tax proposals -- there would be winners and losers in each income class. Those who now reduce their taxable incomes substantially by utilizing the various tax expenditures would face tax increases while those now paying tax on all or most of their real incomes would have tax decreases.

The elimination of tax expenditures would not only greatly simplify the income tax, improve equity and lower rates, it would greatly improve the economic efficiency of the income tax. Gross economic distortions are encouraged under our existing system because decisions -- particularly investment decisions -- are greatly influenced by the availability, or lack of availability, of various tax benefits.

The lower marginal rates permitted by base broadening would most likely increase incentives and improve compliance. Lower marginal rates would also decrease the pressures for further tax expenditures. As the proliferation of tax expenditures narrows the tax base requiring higher rates, those subject to such rates seek relief by pressing their own special tax provisions.

When the average Americans see their friends and neighbors reducing their tax burdens through these tax preferences, respect for and, therefore, compliance with the tax system erodes. Since the tax system depends on voluntary compliance, the effect of loss of respect on government's ability to raise needed revenues is enormous. Noncompliance is a problem of major proportions.

These same tax expenditures are also responsible for the proliferation of tax shelters that siphon off scarce capital from productive activities. Not only do tax shelters drain investment into unproductive ventures, they also impede the ability of IRS and Treasury to administer the tax laws. This is an extremely serious problem. But the only way to deal with it is to restructure the tax system by eliminating the tax expenditures which form the basis for all shelters. The kind of tinkering we have been doing these past 10 years has not solved the problem and, in fact, has added enormously to the complexity of the system.

While all proposals for reform that I have seen would substantially simplify the tax base and reduce the rates, agreement ends at that point. Some would advocate a single flat rate rather than progressive rates and some would tax only consumption rather than income -- the difference being that deductions from income would be taken for savings and borrowing would be taxed.

Simplifying our tax system and making it fairer do not require us to switch to a consumption based tax nor to a flat rate tax. Indeed, if we are seduced into believing that simplification requires a flat rate, we will unnecessarily sacrifice substantial equity for minimal gains in simplification.

While economists and social philosophers may debate whether a progressive tax system is fair, the fact is that most people think it is. It seems reasonable that the costs of government be borne in a manner having a relation to the rewards one receives from the system and that the most affluent can pay proportionately more than those less fortunate. While we are committed to a free enterprise system -- a system relying heavily on economic rewards to provide incentives -- we also recognize that this system requires constraints if it is to work effectively and fairly. We have child labor laws and antitrust laws to moderate the potential for abuse of uncontrolled free enterprise. While most believe deeply in rewards and incentives, most also believe there must be some limits. Reasonably progressive tax rates are a way to moderate the rewards our economic system might otherwise bestow and at the same time leave ample incentive to drive and reward the most able.

A tax system such as ours -- which relies heavily on taxpayer cooperation -- can only work if most taxpayers perceive the system as fair. The perceived fairness of progressive tax rates are too much a part of our political and social structure to be abandoned.

Much the same can be said in criticism of consumption based taxes. A tax based on consumption has the same incidence as a tax on wages only, one exempting all property income -- interest, dividends and rent -- from tax. Surely, such a tax would be perceived as less fair than our present system with all of its loopholes. More affluent taxpayers spend proportionately less of their incomes than those less affluent. Even with steeply progressive rates, consumption taxes are regressive at the highest income levels.

Consumption taxes have been proposed in two forms. One -- an income based consumption tax -- starts with income, adds borrowing and deducts savings. The other is in the form of a sales tax or value added tax.

There is a benchmark against which to measure the performance of a tax. The reason we have a tax based on income (as opposed to consumption) is because we believe that it is fair to allocate the tax burden according to financial well-being and that income is a fair measure of financial well-being. A consumption tax, exempting as it does property income and placing the entire tax burden on labor income does violence to that principle. Moreover it would introduce new complexities and uncertainties into the tax system and the difficulties of transition from an income tax to a consumption tax may well be insurmountable.

That same criticism would be equally applicable to a value added tax. People often assert that a VAT would be both fair and simple. That is a serious misperception. A VAT is not only regressive, it is very complicated and if operated in parallel with our income tax, as is most often suggested, would add enormously to the administrative problems faced by the IRS and the complexities faced by taxpayers.

In my view, the problems with our tax system may best be solved by an overhaul of the system we know best, the income tax, by substantially eliminating tax expenditures, thereby dramatically simplifying its structure, and substantially lowering rates, but maintaining progressivity.

Senator Bill Bradley and Representative Richard Gephardt have proposed a plan which would accomplish these goals and at the same time leave the average tax burdens in each income class approximately the same as they are under current law. Under this plan, the personal exemptions would be raised from $1,000 to $1,600 per taxpayer and $1,000 per dependent. The zero bracket amount would be increased from $3,400 on a joint return to $6,000. Thus, a family of four would pay no income tax on the first $11,200 of income. Then a 14 percent rate would aply to all over that amount.

However, there would be an additional tax at rates of 12 percent on income in excess of $40,000 for joint returns and 16 percent on incomes over $65,000. Therefore, income would be subject to taxes at the top rate of 30 percent.

The Bradley-Gephardt bill retains mildly progressive rates. The aim of its proposed rate structure is to match closely the present distribution of the income tax burden by income class. One can well debate whether that is sufficiently progressive, but it demonstrates that these progressive rates are necessary to maintain the relative status quo. It does not move us into a regressive structure as all of the flat rate proposals would. And it is preferable to the Kemp-Kasten bill which is only progressive over the lower two-thirds of the income range. Unlike Bradley-Gephardt, which remains progressivity over the upper ranges, Kemp-Kasten ceases to be progressive at an income level of about $75,000. It will thus reduce taxes for the wealthiest members of our society.

The Bradley-Gephardt bill would eliminate most tax expenditures -- percentage depletion, the investment credit, expensing of intangible drilling costs for oil and gas wells, fast amortization of pollution control facilities, general exclusion of interest and dividends, the deduction for long-term capital gains, the various energy credits, the exclusion of unemployment and disability payments, the exclusion of premiums on group term life insurance, the credit for political contributions, the deduction for casualty losses and many more.

On the other hand, it would retain as deductions, but only against the basic 14 percent rate, home mortgage interest, charitable contributions, and state and local real estate and income taxes. This is a fair compromise.

Many people have made long-term commitments to buy homes based on the deductibility of mortgage interest and real estate taxes. And the marketplace has, in many cases, adjusted to the tax system so that prices reflect tax provisions. What may be an ideal tax system if we were starting from scratch cannot, in some cases, be substituted for the existing structure without a transition period -- some time for people and the marketplace to adjust to the changes. This is only true, however, where there are long-term commitments. It is not true for provisions that would apply only to future conduct. I would, however, prefer to see the bill provide for the eventual phasing out of these deductions. The law would be simpler and fairer without them and existing commitments, expectations and market conditions need not be accommodated forever.

Some will point out that any progressivity in rates complicates the income tax system. However, with a broad base, low rates and wide brackets, the degree of complexity attributable to progressivity is minor. Equity is frequently more complex than simplicity. The proper question is how much complexity is worth how much equity. The relative minor problems presented by progressive rates are well worth the fundamental equity they achieve. Most complexity would be eliminated with substantial base broadening and we should not retreat from important notions of fairness to achieve the last morsel of simplification.

Senator Bradley and Representative Gephardt have introduced a corporate tax proposal along the same lines as the individual income tax proposal. It is needed. Our corporate tax was virtually legislated out of existence by the Economic Recovery Tax Act and this inevitably puts greater burdens on individuals. The corporate tax should be restored as a real contributor to our revenue needs. Equally important, the Bradley-Gephardt approach, particularly in its approach to capital recovery allowances, would remove the wide differentials in effective tax rates that distort investment decisions and seriously misallocate our economy's resources.

A new tax structure will not come into being overnight. The simplificaton debate is just beginning. But so far, Bradley-Gephardt is the most thoughtful entry.

STATEMENT OF CHARLS E. WALKER, CHAIRMAN, THE AMERICAN COUNCIL FOR CAPITAL FORMATION, WASHINGTON, DC

Mr. WALKER. Mr. Chairman, my formal testimony gives the ACCF position on what we think should be done in broad terms, and I am submitting for the record a special ACCF report which gives my own personal views on fundamental tax reform.

The CHAIRMAN. The American Council for Capital Formation—right?

Mr. WALKER. Yes, the American Council for Capital Formation. What I would like to do in my oral summary is to point out what I think should not be done in Federal taxation. First, as we all know, the economic numbers are now excellent. We are realizing less inflation, more growth, and a vibrant economy. A big reason is an economic recovery in which business-fixed investment is the strongest since 1949. How can it be so strong in the light of high interest rates? More and more analysts are looking at the effect of the 1981 tax reductions on business, specifically the accelerated cost recover system [ACRS] that was put in place at that time. These tax cuts raised the after-tax return on capital and also bolstered business cash flows. The resulting surge in business investment is good in the short run because it bolsters the recovery. It is even better in the long run because it sows the seeds of greater productivity in the years ahead as that investment comes to fruition.

And this has happened even though we lost 32 percent of ACRS in the 1982 TEFRA legislation. I urge this committee now and in the future to protect the existing ACRS system. It is working and working beautifully. If it ain't broke, don't fix it. And it ain't broke.

Second, we may disagree among ourselves as to precisely why deficits are bad, but on one aspect there is not that much disagreement. One aspect of the deficits that loom ahead. And that is that the deficits will absorb too much of our net national savings—over 50 percent, maybe 60 percent, maybe 70 percent. That means that much less saving will be available for capital formation. It means funds are not available for home-building and buying, purchases of automobiles, and so forth.

Therefore, as we assess deficit reduction plans, we ought to take a hard look at tax proposals which would hit business and reduce business savings. Similarly, we should be skeptical of tax increases on upper income individuals where the savings rate is high. If you put a tax on people with high incomes, a big portion of that tax increase is going to come out of saving, not out of consumption. If you are trying to reduce Uncle Sam's dissaving—in the form of a deficit—with a tax that reduces saving in the private sector, you are doing no better than running in place. That sort of deficit reduction is form, not a substance.

In conclusion, let me simply say that the essence of both deficit reduction and tax reform—if we tie the two together—is in my view to move very strongly toward consumption taxes as an addition to, but not a substitute for, the current system.

Let me call the committee's attention to three reports that we have submitted for the record from the American Council for Capital Formation and our ACCF Center for Policy Research. The first is my own personal view on the tax reform deficit reduction picture. The second is a special report on expenditure tax options, and the third, is our special report comparing congressional proposals for fundamental tax reform. We have a spreadsheet where at a moment's notice you can see what FAST, FLAT, FAIR, and so forth, do. Thank you.

The CHAIRMAN. Thank you very much.

[Mr. Walker's prepared written statement follows:]

Statement of Dr. Charls E. Walker
Chairman, American Council for Capital Formation
before the
Senate Committee on Finance

Tuesday, August 7, 1984

My name is Charls E. Walker. I am voluntary Chairman of the American Council for Capital Formation. I appreciate the opportunity to testify on tax reform.

The American Council for Capital Formation is a nonpartisan, nonprofit organization comprised of individuals, corporations, and associations united in their support of government policies to encourage the productive capital formation needed to sustain economic growth, reduce inflation, restore productivity gains, and create jobs for an expanding American work force. We have been concerned about fundamental tax reform for a long time.

What is fundamental tax reform?

Fundamental tax reform aims at making the tax system work better in terms of all of its characteristics. In the past, reform has focused too often on only one aspect of the tax system, namely, horizontal equity, or the degree to which taxpayers with similar amounts of income pay similar amounts of income taxes. This is also called "loophole closing."

Other important characteristics of the tax system should be considered. These include simplicity, vertical equity, efficiency and viability.

Simplicity is clear enough.

Vertical equity is fairness among people with different levels of income. This gets into progressivity of the tax system, whether there is too much or too little.

Efficiency in the tax system means at least two things. Does the tax system bring forth a reasonable amount of revenue as compared with the cost (both to the government and taxpayer) of collecting that revenue? Is the tax system efficient in promoting (or at least not inhibiting) achievement of the nation's economic and social goals?

Viability of the tax system means--can it last? Or do taxpayers come to view it as so unfair, so intrusive into personal affairs, or so inefficient that it should be junked? Tax revolts raise questions about the viability of a tax system.

How does the Federal income tax system stack up in meeting these criteria?

In some respects, the U.S. tax system performs very well. Some of its attributes, such as the self assessment procedure for income taxes, have in the past been envied throughout the world. In other respects, our tax system is far less than satisfactory and eminently in need of repair.

First, take vertical equity, or the degree of progressivity. The typical family with an adjusted gross income of $60,000 pays about $9,200 in Federal income taxes; a $20,000 family, about $1,500; and a $15,000 family, about $900.

So, the upper middle-income family pays ten times the taxes on four times the earnings of the $15,000 family. It pays six times the taxes on three times the earnings of the $20,000 family. Moreover, many middle-class Americans are hit with a marginal tax rate of 30 percent or more.

Is this too much progressivity? I think it is and most Americans would agree. The growing popularity of the "flat tax" proposals--reforms that would tax income at a single, low rate--indicates a yearning for less or even no progressivity.

Second, let's honestly look at horizontal equity, the issue of "loopholes." The biggest "loopholes" facilitate middle-income retirement, housing, and health. For retirement, employer contributions to workers' pension plans are tax deductible (but not taxable to the employee), as are individual contributions to Keoghs and IRAs. Interest on life insurance savings is excluded. For homes, both property taxes and mortgage interest are tax deductible. For health, employer contributions to medical plans can be deducted by the business but are not taxable to the employee.

These middle-class "tax loopholes" add up to a whopping $115 billion per year. When the job- and growth-creating investment tax credit is added in, you have a very big portion of the so-called tax loopholes or expenditures.

These "loopholes" are difficult, if not impossible, to close or even shrink modestly. Furthermore, given their contribution to important economic and social goals, there is real question whether such efforts are desirable.

Third, the most serious drawback of the income tax is its economic impact, i.e., its inherent bias against the saving and productive investment that create jobs, growth, and productivity.

Income taxes deter saving because they tax it twice, once when the income is earned and, again, when income on the invested savings is taxed. Moreover, our progressive rate structure results in higher taxes on those upper-income individuals who save the most.

It is true that there are important provisions in the tax Code to encourage saving and investment (provisions that should not be cut back) including our accelerated depreciation system, the investment tax credit, IRAs and Keoghs, and the capital gains tax provisions. But the fact is that these provisions fail to correct entirely for the anti-saving bias of the income tax. The existence of such a tax preference is in itself evidence that the American people believe saving and investment are too heavily taxed and that fundamental tax reform is needed.

Still another economic drawback to our tax system is the fact that it hurts us in international trade. Many competitor nations rely heavily on indirect taxes, such as the value added tax (VAT). A VAT (or any other excise or sales tax) can be forgiven on exports, thereby lowering their cost to foreigners, and added to imports, thereby raising the price of imported goods. Unless relative currency values adjust efficiently, this tax differential puts U.S. producers at a serious competitive disadvantage in international markets.

Also very troublesome from an economic standpoint is the well-known double taxation of corporate profits. The corporation pays an income tax on its profits; so does the stockholder, on dividends paid out of these already taxed profits. The combined marginal tax rate on corporate profits and stockholder dividends can exceed 73 percent (46 percent at the corporate level, another 50 percent at the individual level plus state taxes). Such heavy taxes lower the after-tax rate of return on investment and also reduce the cash available for such investment. That's very bad for capital formation.

Fourth, the viability of the income tax is now in question. The tax is increasingly unpopular. The Advisory Council on Intergovernmental Relations (ACIR), a respected organization, polled the public last summer with this question: "Suppose your Federal, State, and local government must raise taxes. Which way would be a better way to do it?" The answers? Fifty-two percent favored a sales tax. Only 24 percent spoke out for an income tax.

If deficits in the range of $200 billion per year are to be eliminated, and if the amount of revenue needed in a balanced deficit reduction program is in the range of $100 billion per year, the income tax is not a viable option. For example, if revenues have to be increased by $100 billion per year through higher income taxes, individual and corporate tax rates would have to be increased by at least 25 percent. If the increase were applied to all corporations, but limited to individuals with incomes of $40,000 or more, the necessary surtax would be a whopping 45 percent!

Such increases are politically impossible for a tax that is already in serious--and growing--disrepute.

What is the alternative?

The American Council for Capital Formation has long advocated tax reform proposals to ameliorate the bias against saving and investment in our current income tax system. If revenues need to be raised, an appropriate approach would be some sort of consumption tax, a levy that hits expenditure, rather than income, and automatically exempts the saving and investment that is so crucial to productivity and growth. Polls such as the one conducted by ACIR indicate that taxes on retail sales, a form of consumption tax, are "less unpopular" than income taxes. Consumption tax alternatives include the Consumed Income Tax, the National Retail Sales Tax, the Value Added Tax, and the Tax on Business Transactions (the last is a VAT which is not applied at the retail level).

The American Council for Capital Formation is currently studying the pros and cons of these and other tax restructuring options. Federal revenue needs are so great and the income tax is so weak that fundamental reform may be a necessity. The key is the need for a new or supplemental tax base, one that is both economically and politically sturdy.

I offer for the record of this hearing three Special Reports on "Expenditure Tax Options," "The Case for Fundamental Tax Reform," and "Congressional Proposals for Fundamental Tax Reform," recently published by our education and research affiliate, the ACCF: Center for Policy Research.

ACCF: Center for Policy Research

Special Report on Expenditure Tax Options

The following is an ACCF: Center for Policy Research staff paper prepared to highlight the pros and cons of the various expenditure tax options. The authors are Mari Lee Dunn, Vice President, and Margo Thorning, Director of Research, of the ACCF: Center for Policy Research.

Background

U.S. economic growth has been relatively poor in recent decades. Many of our international competitors have surpassed the U.S. in real economic growth and manufacturing productivity. In fact, per capita Gross Domestic Product (GDP) grew at an annual rate of only 1.5 percent in the U.S. from 1970 to 1982, according to the Bureau of Labor Statistics. Comparable rates of growth in GDP were 2.0 percent in Canada, 3.5 percent in Japan, 2.6 percent in France and 2.1 percent in West Germany over the same period.

Part of the explanation for the comparatively slow rate of economic growth in the U.S. can be found in the low rate of saving and investment. As Table 1 (above) indicates, saving and investment as a percent of Gross Domestic Product was lower in the U.S. during the 1972-1981 period than in any of our major competitors (except the United Kingdom).

Table 1: Saving and Investment as a Percent of Gross Domestic Product 1972-1981

	U.S.	Canada	Japan	France	W. Ger.	U.K.
SAVING						
Saving as a Percent of Gross Domestic Product	8.8	10.6	19.8	11.5	11.6	7.3
Saving + Consumption of Fixed Capital as a Percent of Gross Domestic Product[1]	18.1	21.8	32.2	22.6	22.9	16.6
INVESTMENT						
Gross Non-Residential Fixed Capital Formation as a Percentage of Gross Domestic Product	14.1	17.5	24.8	15.6	15.3	14.9
Gross Fixed Capital Formation as a Percentage of Gross Domestic Product	18.5	23.0	32.2	22.3	21.8	18.0

[1] SAVING + CONSUMPTION OF FIXED CAPITAL is the equivalent of saving plus depreciation charges.

Source: Derived from NATIONAL ACCOUNTS, 1964-1981, Vol. II, Organization for Economic Cooperation and Development, Paris, 1983.

Many U.S. tax policy experts contend that the current U.S. Federal income tax structure is biased against saving because, with a few exceptions, income is taxed when it is first earned and, again, when the savings generate additional income. Other countries have much higher saving rates than the U.S., because their tax laws favor saving. In contrast, the U.S. income tax Code discourages saving and subsidizes consumption.

What are our Options?

How could the U.S. tax Code be restructured to promote the additional saving and investment needed to increase both productivity and economic growth? A consensus is emerging among tax experts in academia, as well as businessmen and public officials, that suggests more reliance on expenditure taxes and less on individual and corporate income taxes would promote the higher rates of saving and investment needed for economic growth and full employment. In addition, to the extent that deficit reduction cannot be accompanied by spending cuts alone, taxing consumption would be less detrimental to the economy than additional income taxes.

Many of our international competitors rely to a much larger extent on expenditure taxes and to a lesser extent on income taxes than does the U.S. (see Table 2 below). A recent survey shows that several countries whose growth rates have exceeded that of the U.S. in recent years raise relatively more tax revenue through expenditure taxes than does the U.S.[2] These countries also have higher saving rates than does the U.S. (see Table 1 above).

A brief description of the major expenditure tax options and the commonly cited advantages and disadvantages are presented in Tables 3 and 4. Expenditure tax option (1), i.e. Broad Based Expenditure Tax (BBET), is a substitute for the current income tax system. The remaining options could be combined with the current tax system.

Table 2: Distribution of Major Sources of Tax Revenue in Selected Countries in 1980

– (percent of total taxes from each source)

	Taxes on Income				Taxes on
Country	Individual	Corporate	Payroll	Total	Goods/Services
Canada	34.02	11.34	10.41	55.77	32.82
France	12.92	5.04	43.16	61.12	29.[illegible]
W. Germany	29.92	5.51	34.10	69.53	26.09
Japan	24.22	17.28	29.02	70.52	16.35
U.K.	30.02	7.69	16.87	54.58	28.81
U.S.	36.80	10.13	26.41	73.34	16.81

Source: The Tax Foundation, "OECD Nations Use Wide Range of Taxes," Vol. 27, No. 3, November/December 1983.

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[2] In the sample shown above in Table 1, only the United Kingdom has had a lower growth rate than the United States.

Table 3: Expenditure Tax Options

Description	Advantages	Disadvantages
1. **Broad Based Expenditure Tax.** An expenditure (or consumption) tax could be substituted for part or all of our current Federal individual and corporate income tax. There are many ways such a tax system could be structured; the "Consumed Income" and "Prepayment" types are described below. a. **The Consumed Income Tax.** Under this approach, also known as the Cash Flow Expenditure Tax, each taxpayer would report all monetary receipts received during the year, including wages and salaries, gross business receipts, dividends, interest, rents, borrowed money, and proceeds from the sale of assets, bequests and withdrawals from past savings. The taxpayer would subtract from his total monetary receipts all current saving, including purchases of stocks, bonds, and income-producing assets, repayment of debt and gifts made. All forms of saving would be deductible without limit, including investment in businesses. The definition of income would be broadened to include all receipts; for example, the entire proceeds from the sale of a capital asset (not just the capital gain) would be included in monetary receipts. The tax would be imposed only on individuals. The corporate income tax would be eliminated. b. **Prepayment Expenditure Tax.** No deduction would be allowed for new savings and no tax would be due when savings and interest were withdrawn and consumed. Thus, the tax would have been "prepaid." **Revenue Estimates** — A preliminary Congressional Budget Office (CBO) study estimates that a broad based expenditure tax with marginal rates ranging from 10 to 35 percent would yield $298 billion, the same amount of tax revenue as would our current tax system in 1984.	1. An expenditure tax does not distort the trade-off between present and future consumption. An expenditure tax system would eliminate the existing tax bias against saving and investment and toward consumption, thereby encouraging capital formation. Higher levels of capital formation would permit faster economic growth and higher living standards. 2. A taxpayer's lifetime income may be a more appropriate base for taxation than is annual income. Inasmuch as income streams may vary greatly over individual taxpayers' lifetimes, annual consumption is considered to be a better proxy for lifetime income than is annual income. Other reasons offered for taxing consumption rather than income are that individuals should be taxed on the output they withdraw from the economy rather than what they contribute to future productive capacity through their savings; consumption is a better measure of ability to pay tax; and it is unfair to tax saving twice— once when the income is initially earned and again when the savings have earned interest. 3. A true expenditure tax would eliminate the corporate income tax. Dividends would be taxed when used to pay for consumption and retained earnings would be reflected in higher stock prices and, hence, taxed in full when stock was sold for consumption. Eliminating the corporate tax would eliminate the double tax on dividends and end the present tax discrimination against incorporated businesses and the current bias favoring debt compared to equity financing. Corporate income would be taxed only once, at the rate applying to the stockholder and only to the extent it was used to finance consumption. 4. Tax rates can be structured to achieve the degree of progressivity desired, thereby addressing the issue of vertical equity. 5. A consumption tax system undermines the rationale for tax shelters, because it extends immediate write-offs to all saving and investment and eliminates all differential tax advantages for specific forms of investment. 6. An expenditure tax would be neutral with respect to financing consumer purchases by saving or by debt finance. The proceeds from loans would be included in the borrower's tax base. Loan repayments would be deductible from the new tax base. 7. Under current law, certain types of saving and investment receive preferential tax treatment so that tax rates on capital income vary widely. The economic distortions which result would not exist under a pure expenditure tax. 8. With the reduction or removal of burdensome income taxes, foreign capital would be attracted to the U.S. 9. Under a proportional consumption tax, the same amount of tax is collected from individuals with equal initial wealth and lifetime income, regardless of when they spend their money. In contrast, even a proportional income tax takes more from the person who saves in order to consume later in life than from the person who spends early in life. 10. The higher levels of saving anticipated under a consumption based tax system would tend to reduce the amount of funds needed for transfer payments. That is, individuals could save more to meet future needs and provide for emergencies. 11. A consumed income tax system avoids most of the difficult measurement problems which arise under a comprehensive income tax.[1] For example, there is no need for depreciation schedules, records of asset acquisitions, inflation adjustments, nor the allocation of undistributed corporate income because all such forms of saving would be excluded from the tax base. Thus, the tax system would be administratively simpler for the business sector than our current income tax. 12. A consumption tax would offer an opportunity to tax accumulated wealth which has escaped tax under our current system. When income previously accumulated is spent for consumption, it would be subject to tax. [1] A truly comprehensive income tax would include the sum of consumption and changes in a person's net wealth. This would include: salary, investment returns, including unrealized capital gains and losses; gifts, and transfer payments. Deductions would only be allowed for the purpose of acquiring income. The corporate tax would be integrated with the personal income tax.	1. An expenditure tax could burden low income individuals disproportionately because they would pay a higher fraction of their current income in taxes than would high income individuals. The burden of the tax on low income individuals could be offset, however, by exempting from tax a certain amount of consumption spending for each individual or by using a progressive tax rate. 2. Restructuring our tax system, whether through a broad based expenditure tax or through some other system, would involve transition problems. First, a drastic change in the tax system would involve carryover problems. Carryover problems would occur to the extent that changes in the tax Code affect the taxation of income earned in the past but not yet subject to tax, or conversely, income taxed in the past that may be subject to a second tax. Second, price changes for assets would occur in those instances where changes in the tax Code altered the expected flow of after-tax income from existing investments in the future. The resulting changes in asset prices would result in windfall gains and losses that might not be in accord with social policy. These transition problems can be addressed through "grandfathering" existing assets and phasing in new rules slowly. 3. Because the base of an expenditure tax would be smaller than the base of a comprehensive income tax, the average rate of an expenditure tax would have to be higher than that of a comparable income tax in order to obtain the same amount of revenue. 4. Our current income tax treaties with other countries would have to be renegotiated since no other country taxes individuals exclusively on the basis of consumption. For example, people could earn income in the U.S. and retire elsewhere to consume it. Thus, they would pay less tax over their lifetimes than those who stayed in the U.S. Likewise, it would be unfair to require resident foreigners who earn their income in a country which taxes income to pay tax on their consumption in the U.S. 5. A consumption based tax system would probably be as complex as the current income tax for the average taxpayer. Also, new problems of enforcement and administration would arise. 6. A consumption based tax system would tend to increase the concentration of wealth because no tax liability would result from the earnings of accumulated saving. However, when the funds were spent for consumption, they would be subject to the consumption tax. 7. Addressing the issue of vertical equity by graduating the rates of a Broad Based Expenditure Tax would cause distortion of the intertemporal distribution of consumption.
2. **Value Added Tax.** A value added tax is a tax paid by a business firm, unincorporated as well as incorporated, on the additions it makes to the value of products or services as they pass through the firm in their progress from raw material to final goods. A company's addition to the value of the products or services is equal to the cost the company incurs for the labor and capital it uses in its production activity subject to certain adjustments, depending on the particular type of VAT employed. With a consumption type VAT such as that adopted by the European Economic Community, the VAT tax base is the firm's gross sales less its purchases of inputs, including capital equipment, from other firms. In Europe, the VAT is often levied at the retail level with frequent exceptions for food and other necessities. Food items and some services are either exempt from the VAT or taxed at lower than standard rates. The VAT is rebated on exports and imposed on imports. **Revenue estimates** — CBO estimates that a 10 percent VAT could yield $100 to $200 billion annually (at 1984 income levels) depending on the comprehensiveness of the base.	1. A VAT is neutral with respect to the saving/consumption decision. Saving should increase significantly if the bias against it in our current tax Code is removed. 2. A VAT, combined with the reduction of individual and corporate income tax rates, would increase economic efficiency. That is, output and income would be larger than otherwise. The efficiency gains would result from the fact that a firm's choice of production inputs would not be as biased as is currently the case due to the current tax Code's varying rates of tax on labor and capital. Also, efficiency gains would accrue from reducing the tax rate differential between firms organized as corporations compared to partnerships and proprietorships. 3. A comprehensive VAT is a proportional tax on lifetime income, just as is a Broad Based Expenditure Tax. A taxpayer's lifetime income may be a more appropriate base for taxation than is annual income. Inasmuch as income streams vary greatly over individual taxpayers' lifetimes, annual consumption is considered to be a better proxy for lifetime income than is annual income. Other reasons offered for taxing consumption rather than income are that individuals should be taxed on the output they withdraw from the economy rather than what they contribute to future productive capacity through their savings; consumption is a better measure of ability to pay tax; and it is unfair to tax saving twice — once when the income is initially earned and again when the savings have earned interest. 4. A VAT could easily raise large amounts of revenue relative to administrative and enforcement costs. 5. A VAT need not affect the price level unless it is accompanied by an accommodating monetary policy. 6. Substitution of a VAT for the corporate income tax would improve the after-tax return on domestic investment; higher after-tax returns would encourage American firms to invest at home and might also encourage capital inflow from foreign investors. The U.S. balance of payments on current accounts might tend to improve.	1. A VAT would tend to burden low income individuals disproportionately because they consume a larger fraction of their income than do higher income individuals. However, this could be offset by a refundable credit for low income families or by applying lower rates to necessities. 2. State and local governments might be reluctant to see a VAT imposed because it would appear to them to be an intrusion into a revenue source on which they have traditionally relied. They might find it difficult to raise their sales tax rates if a Federal VAT were in effect. 3. Administering a VAT tax might be complex because of the need for new personnel and tax collection procedures. 4. Because a VAT could easily raise large amounts of revenue, its use could encourage the expansion of the public sector. To control this tendency, the level of the VAT could be constitutionally limited. However, such a mandate might be difficult to enact.

Description	Advantages	Disadvantages
	7. The U.S. trade balance might improve if a VAT were substituted for the Social Security tax or the corporate income tax and the VAT were made rebatable on exports. Such a substitution would tend to lower producer's costs and could lead to lower export prices, thus making U.S. goods more competitive in international markets. Export production would become relatively more profitable than domestic production; producers might then shift resources to the production of exports. Accordingly, the dollar volume of export sales might tend to expand. 8. Since foreign goods imported into the U.S. would be subject to the VAT and would, therefore, be relatively more expensive than before, the U.S. trade balance might improve.	
3. **Tax on Business Transactions** (TBT) — A TBT could also be substituted for part or all of the current Federal individual and corporate income tax. The TBT would be levied on the difference between the value of a firm's sales, whether incorporated or unincorporated, and the value of the purchased material inputs and capital equipment used in producing goods sold. The TBT tax base is also equal to the sum of wages and salaries, interest payments, and profits before tax earned by a firm. The TBT would differ from a Value Added Tax because the value added at the retail level would not be included in the tax base. Retail sales, imports, investments and real estate, and outlays for personal, educational and health services, would be excluded from the TBT tax base. The TBT would be rebatable on exports and imposed on imports. **Revenue Estimate** — Private estimates show that each percentage point of a TBT taking effect in 1988 would yield $9 billion. By 1992, each percentage point could yield $15 billion; a 15 percent TBT would yield $225 annually.	1. Capital formation would be encouraged because saving and investment would be excluded from direct taxation under the TBT. Economic growth would be more rapid if the rate of saving and investment increased. 2. The revenue base would increase in step with GNP, thereby providing a more stable source of revenue than income taxes. 3. The TBT would probably be easier to administer than our current income tax. 4. The TBT would be more palatable politically than a VAT because no explicit tax would be imposed on most consumer purchases. 5. As with a VAT, the substitution of the TBT for the corporate income tax would improve the aftertax return on domestic investment. As a result, both domestic and foreign investors would tend to invest more in the U.S. The U.S. balance of payments on current account might tend to improve. 6. The U.S. trade balance might improve if a TBT were substituted for the Social Security tax or the corporate income tax, and the TBT were made rebatable on exports. Such a substitution would tend to lower producers' costs and could lead to lower export prices, thus making U.S. goods more competitive in international markets. Export production would become relatively more profitable than domestic production; producers might then shift resources to the production of exports. Accordingly, the dollar volume of export sales might tend to expand. 7. Since foreign goods imported into the U.S. would be subject to the TBT and would, therefore, be relatively more expensive than before, the U.S. trade balance might improve.	1. If the TBT were passed forward to consumers it could be regressive in impact. However, if necessary, any regressive impact could be offset with a refundable tax credit. 2. Some states, such as Michigan, which use a VAT or a sales tax at the manufacturers' or wholesale level, might be reluctant to see a TBT imposed because it would appear to be an intrusion into an area on which they have traditionally relied for revenue. They might find it difficult to raise their state tax rates if a Federal TBT were in effect.
4. **Sales Tax.** A retail sales tax is usually a percentage of the selling price of a product. The tax base for a national retail sales tax would be the aggregate amount of retail sales. The tax could be made rebatable on exports and levied on imports. **Revenue Estimate** — The tax base for a national sales tax would equal the sum of all the "value added" during the various stages of production. Therefore, the potential yield of a sales tax is the same as that of a VAT discussed in Section 2. For example, estimates indicate a comprehensive 10 percent sales tax would yield about [illegible] billion at 1984 income levels.	1. A retail sales tax would tax final consumption and would, therefore, eliminate the tax bias against saving in our current tax Code if used as a substitute for income taxes. 2. A retail sales tax offers little opportunity for fraud and evasion. 3. A retail sales tax offers the great advantage of familiarity; it is in use in 45 states. 4. A retail sales tax would be easier to administer than a VAT because it would involve fewer taxpayers. Also, it requires less record keeping than a VAT since retailers need not keep track of taxes paid on their own purchases. 5. A recent survey performed for the Advisory Commission on Intergovernmental Relations found that 52 percent of the public favored sales taxes if additional Federal tax revenues are needed. In contrast, only 24 percent favored increasing the income tax. 6. Substitution of a sales tax for the corporation income tax would improve the after-tax return on domestic investment. Higher after-tax returns would encourage American firms to invest at home and might also encourage capital inflow from foreign investors. The U.S. balance of payments on current account might tend to improve. 7. The U.S. trade balance might improve if a sales tax were substituted for the Social Security tax or the corporate income tax and if a sales tax were made rebatable on exports. Such a substitution would tend to lower producers' costs and could lead to lower export prices, thus making U.S. goods more competitive in international markets. Export production would become more profitable than domestic production; producers might then shift resources to the production of exports. Accordingly, the dollar volume of export sales might tend to expand. 8. Since foreign goods imported into the U.S. would be subject to the retail sales tax and would, therefore, be relatively more expensive than before, the U.S. trade balance might improve.	1. Like a VAT, a retail sales tax would tend to make the tax Code more regressive unless offset by refundable tax credits or lower tax rates on necessities. 2. As with a VAT and a TBT, state and local governments might be reluctant to see a sales tax imposed because it would appear to them to be an intrusion into an area on which they have traditionally relied for revenue. They might find it difficult to raise their sales tax rates if a Federal sales tax were in effect.
5. **Excise Taxes.** An excise tax is a sales tax levied on a specific product or service. Most Federal excise taxes are levied on a unit basis (e.g., the gasoline and alcohol taxes), or as a percentage of selling prices on selected products (Ad Valorem taxes). An example of an Ad Valorem tax is the telephone tax. **Revenue Estimates** — OMB estimates that existing excise taxes will yield $38 billion in 1984. If the current tax rates on alcohol were doubled, CBO estimates revenue would increase by about $4.0 billion annually. Continuing the current level of taxes on cigarettes and telephones beyond their scheduled expiration date in 1985 could yield an additional $2 to $4 billion annually. CBO estimates that a 10 percent tax on luxuries, such as furs and jewelry, would yield about $2.4 billion per year.	1. Excise taxes are relatively easy to administer. 2. Relying more on excise taxes and less on income taxes would help reduce the bias against saving and investment in the tax Code.	1. Increasing existing excise taxes might be regressive if the burden fell more heavily on those with lower incomes. 2. Government influence over the allocation of resources will be increased by selectively making some consumer goods more costly than they would otherwise be. 3. Because excise taxes are placed on selected goods and services rather than on all items, they distort the efficiency of the marketplace. 4. Many excise taxes were enacted on a temporary basis. As a result, they are not necessarily a stable revenue base.
6. **Energy Taxes.** New taxes on energy could include both additional excise taxes set as a percent of the selling price and flat fees, such as a $2 per barrel oil import tax. a. **Gasoline Excise Taxes.** The Federal excise tax on gasoline, which was raised from $.04 to $.09 in April 1983, could be increased again. b. **Natural Gas.** Decontrol of both old and new gas, accompanied by an excise tax on gas producers, could raise a substantial amount of revenue. c. **Oil Import Fees and Taxes on Domestic Oil.** A tariff on imported oil and refined products could be levied on oil importers and would raise a significant amount of tax revenue. Domestic crude oil producers could also be subject to additional levies, in addition to the Windfall Profits Tax. d. **BTU Taxes.** A tax based on the heat content of various fuels (e.g., coal, natural gas, and fuel oil) could raise substantial amounts of revenue. Such a tax could be imposed either at the wholesale or retail level.	1. Increasing gasoline taxes would be a simple way to raise revenue because the mechanism for collecting the tax is in place. Taxing gasoline users more would tend to make them pay a greater share of the costs associated with maintaining access to oil from the Persian Gulf. 2. Natural gas decontrol would serve the dual goal of stimulating exploration and promoting conservation by consumers and industrial users. In addition, decontrol would eliminate inequitable discrepancies in gas prices across the country. An excise tax on gas might improve the chances of decontrol being enacted. 3. Oil import fees and taxes on domestic oil would be relatively easy to administer. A tariff on imported oil would tend to depress imports, thereby reducing our dependence on foreign oil. Since domestic as well as foreign oil would reflect the impact of the tariff, higher prices for oil would encourage the substitution of coal, natural gas, and other fuels for oil. The existing world oil glut would help minimize the extent of the pass-through to consumers. 4. A BTU or Ad Valorem tax on all energy sources, including coal and nuclear, would be more equitable than a tax aimed at only one energy sector.	(Most of the same arguments against energy taxes apply to each of the types of taxes described here.) 1. Higher taxes on energy would cause higher prices for energy users. As energy users substitute capital and labor for the now higher priced energy, this less efficient combination of resources would be associated with a slower rate of growth in GNP, at least in the short run. 2. All new energy taxes would tend to make U.S. goods with substantial energy inputs less competitive with those of foreign producers. 3. Increasing taxes on energy would burden low income energy consumers, since they spend a large fraction of their income on energy consumption. 4. Taxes based on the heat content of various fuels would tend to alter the current relative prices of energy; gas and coal would become relatively more expensive. Changing relative prices might slow economic growth, at least in the short run. 5. Since plant and equipment in the U.S. was designed with certain assumptions about energy price paths, a sharp increase in energy prices would result in the obsolescence of some of that capital stock.

Description	Advantages	Disadvantages
a. Ad Valorem Taxes. An Ad Valorem tax, based on the selling price of all types of energy consumed in the U.S., could raise substantial amounts of revenue. The tax could be imposed either at the wholesale or retail level. Revenue Estimates a. Gasoline tax — CBO estimates that increasing the gasoline excise tax by five cents per gallon would yield $3.2 billion in 1985 and $20.7 billion over the 1985-1989 period. b. Natural Gas — CBO estimates that decontrol of all natural gas accompanied by an excise tax could raise $5 billion in 1985. Alternatively, a simple excise tax on all gas of 30 cents per 1000 cubic feet could raise about $3.5 to $4 billion per year or $17.5 billion over the 1985-1989 period. c. Oil Import fees and Taxes on Domestic Oil — CBO estimates that a tax of $2 per barrel could raise $3.7 billion in 1986 and $28.3 billion over the 1985-1989 period. d. BTU and Ad Valorem taxes — Could be set to raise large amounts of revenue. For example, CBO estimates that a 5 percent Ad Valorem tax would raise $10.7 billion in 1985 and 282.9 billion over the 1985-1989 period.		6. Some energy taxes, like an oil import fee, would cause regional inequities. An oil import fee would affect the northeast more than other parts of the country because of its dependence on fuel oil for electricity and home heating. 7. An excise tax on new natural gas production would discourage exploration and development and so would reduce the chief benefit of decontrol.
7. Customs Duty. Customs duties are taxes paid as a percentage of value by an importer on goods brought into the country. Revenue Estimates — Customs duties currently yield about $9 billion annually. Doubling the duty rates would probably bring in substantially less than double the current level of revenues as consumers substitute domestic for imported products.	1. Customs duties can be targeted to protect certain domestic industries which are adapting to changing markets. 2. Customs duties can be targeted to achieve specific purposes. For example, goods consumed by lower income individuals could be exempt. Other specific items, like capital equipment, could be exempt.	1. New customs duties would be opposed by the U.S. trading partners who might retaliate by raising their duties. 2. Increased customs duties could contribute to increases in the price level and could also protect inefficient domestic producers. 3. Customs duties imposed to protect domestic industries during a transition period tend to remain in force after the need for protection has disappeared.

Table 4: Rating the Major Expenditure Taxes

	Criteria			
	Political Acceptability	**Ease of Administration**	**Transition Problems**	**International Compatibility**
1. Broad Based Expenditure Tax (BBET)	Substantial obstacles to political acceptance. A true BBET would eliminate the corporate tax to which those favoring a separate tax on corporations might object. However, a BBET has the advantage of being more progressive than the other major expenditure taxes if a progressive tax rate structure is employed.	Easier to administer than our current income tax because of the elimination of capital gains and corporate tax laws.	Substantial obstacles especially relating to income already taxed that might be taxed again. Changes in the tax Code which alter the expected flow of after-tax income would cause once changes for existing assets.	Reasonably compatible. One problem would be the need to renegotiate our current income tax treaties with other countries. DISC would not be necessary, because corporate tax would be eliminated.
2. Value Added Tax (VAT)	Substantial obstacles to political acceptance. Many Congressmen believe their constituents would oppose a VAT. However, a recent survey shows consumers prefer consumption taxes to income taxes. States and localities might also oppose a VAT.	Easier to administer than a BBET, but might require additional tax collection staff.	Minimal. VAT could be phased-in slowly so that the economy would not be subject to a sudden shock.	Quite compatible. VAT is used in Europe and elsewhere. VAT would be rebatable under the GATT Code.
3. Tax on Business Transactions (TBT)	Could be more acceptable politically than a VAT or National Sales Tax because the tax would be applied only on business transactions and not on consumer transactions.	Easier to administer than a BBET, but would require additional tax collection staff.	Minimal. TBT could be phased-in slowly so that the economy would not be subject to a sudden shock.	Quite compatible. TBT is similar to a VAT and should be rebatable under the GATT Code.
4. National Sales Tax	Substantial obstacles in obtaining Congressional support. Many Congressmen believe their constituents would oppose a National Sales Tax. However, a recent survey shows consumers prefer sales taxes to income taxes. States and localities might also oppose a National Sales Tax.	Easier to administer than a BBET, VAT or TBT because it would involve fewer taxpayers and less record keeping.	Minimal. Sales Taxes could be phased-in slowly so that the economy would not be subject to a sudden shock.	Quite compatible. Sales Taxes are similar to a VAT and should be rebatable under the GATT Code.
5. Energy Tax	Some major obstacles. Congressmen in energy-producing states, major industrial users, and consumer groups would oppose additional taxes on energy because of their impact on energy prices.	Easier to administer than a BBET, VAT or TBT. Some types of energy taxes (e.g., BTU) would probably require additional tax collection staff.	Economy would be subject to a sharp shock if significant taxes were imposed. Part of the nation's capital stock, which was built with certain assumptions about energy prices, would become obsolete.	Reasonably compatible. Energy taxes, if treated as excise taxes by GATT, would be rebatable under the GATT Code.

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Special Report

The Case for Fundamental Tax Reform: Questions and Answers

Charls E. Walker*

Introduction

Conventional wisdom holds that there is little chance that Congress will enact a consumption tax in the foreseeable future. This view prevails even though Americans tell pollsters that, if taxes must go up, they would prefer a sales tax increase over an income tax by a margin of more than two to one. Moreover, more and more informed citizens are coming to recognize that income taxes hamper productivity and growth by heavily taxing saving and investment, whereas a true consumption tax would not directly affect saving and investment. These people argue that a shift toward consumption taxes would represent fundamental tax reform.

Conventional wisdom is not always correct and may again be wrong. The reason this may be so stems from the exigencies of the fiscal situation, particularly the huge structural Federal deficits which extend indefinitely into the future. Four consensuses concerning the deficits appear to have emerged or to be emerging. This centralizing of opinion suggests that a consumption tax may well be an idea whose time is almost here.

Consensus No. 1 holds that the deficits this country faces are not only huge but will not, as with past deficits, drop sharply as a result of economic growth. In the 1970's, deficits declined in the upswing of the business cycle in part because the combination of inflation and a steeply progressive individual income tax system generated huge unlegislated revenue increases. Beginning in 1985, individual tax rates will be indexed for inflation and those unlegislated tax increases will stop. In addition, Federal retirement programs — social security, military, and civil service — are indexed and will, therefore, move steadily upward with inflation. The rapid rise in defense spending will further reduce the chances that economic growth will by itself bring the deficits down. And with interest payments on a ballooning Federal debt rising rapidly, the deficit will — absent policy changes — actually rise in the years ahead.

Consensus No. 2 is that deficits do matter and that they matter a great deal. The additional Federal borrowing that deficits require tends to crowd out other borrowers in credit markets and keeps interest rates higher than they otherwise would be. These higher rates attract foreign capital. This supports a high value for the dollar and depresses exports. High interest rates and tight credit markets contribute to political pressure on the Federal Reserve to monetize the deficits, just as was the case in the 1970's, with double-digit inflation and stagflation the likely result. Huge Federal deficits rapidly elevate the interest portion of the Federal budget.

Consensus No. 3 holds that effective deficit control can come only from some combination of spending restraint and revenue increases. Federal spending is now at 24 percent of GNP, revenues at 19 percent; the deficit gap is 5 percent of GNP. A balanced deficit-reduction program might, therefore, aim at balancing out spending and taxes at 21½ percent of GNP.

(Indeed, achievement of a one percent surplus over the years might work wonders for financial markets and capital formation. As the Federal government retired debt instead of borrowing, interest rates would be lower than otherwise and credit markets would be easier. Interest on the debt would actually decline.)

A balanced deficit-reduction plan would call for cuts in planned spending growth and additional tax revenues of about $100 billion each per year.

Consensus No. 4 is not yet widely held but is instead confined to tax experts and Members of Congress who are close to the tax-writing process. These people are convinced that it would be extremely unwise economically, and impossible politically, to raise up to $100 billion per year in new Federal revenue through the income tax. That amount would require a surtax of 25 percent on all taxpayers — clearly not in the cards politically.

Politicians who argue that income tax increases to pare the deficit should be applied only to corporations and upper-income individuals are not realistic. If the increase were applied to all corporations, but limited to individuals with incomes of $40,000 or more, the necessary surtax would be a whopping 45 percent!

If deficits must be brought down, but the income tax does not provide a viable approach, what is the alternative? The best option available is some form of consumption tax, a levy that is based on expenditure, rather than income, and that automatically exempts the saving and investment that is so crucial to productivity and growth. Polls indicate that taxes on retail sales, a form of consumption tax, are "less unpopular" than income taxes.

The American public and press believe that consumption taxes have some strong inherent drawbacks. On the other hand, many tax experts view a shift toward consumption taxes as representing a long overdue step toward fundamental tax reform.

What follows is a series of questions and answers designed to highlight the issues and increase understanding of this important topic.

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Fundamental Tax Reform

Q. *What is fundamental tax reform? How does it differ from tax reform efforts of the past, as in the Tax Reform Acts of 1969 and 1976?*

A. Fundamental tax reform aims at making the tax system work better in terms of *all* of its characteristics. The 1969 and 1976 efforts concentrated on only one aspect of the tax system, namely, horizontal equity, or the degree to which taxpayers with similar amounts of income pay similar amounts of income taxes. This is also called "loophole closing."

Q. *What other characteristics of the tax system should be considered?*

A. Among others, simplicity, vertical equity, efficiency and viability.

Q. *Simplicity is clear enough. What is vertical equity?*

A. Fairness among people with different levels of income. This gets into progressivity of the tax system, whether there is too much or too little.

Q. *What is meant by efficiency in the tax system?*

A. At least two things. Does the tax system bring forth a reasonable amount of revenue as compared with the cost (both to the government and taxpayer) of collecting that revenue? Is the tax system efficient in promoting (or at least not inhibiting) achievement of the nation's economic and social goals?

Q. *What is meant by viability of the tax system?*

A. Can it last? Or do taxpayers come to view it as so unfair, so intrusive into personal affairs, or so inefficient that it should be junked? Tax revolts raise questions about the viability of a tax system.

Rating the U.S. Tax System

Q. *How does the Federal income tax system stack up in meeting these criteria?*

A. It's a mixed bag. In some respects, the U.S. tax system performs very well. Some of its attributes, such as the self assessment procedure for income taxes, have in the past been envied throughout the world. In other respects, our tax system is far less than satisfactory and eminently in need of repair.

Q. *What are some of the aspects most in need of repair?*

A. Take vertical equity, or the degree of progressivity. The typical family with an adjusted gross income of $60,000 pays about $9,200 in Federal income taxes; a $20,000 family, about $1,500; and a $15,000 family, about $900.

So, the upper middle-income family pays ten times the taxes on four times the earnings of the $15,000 family. It pays six times the taxes on three times the earnings of the $20,000 family.

Q. *Is this because of the progressivity of the rate structure?*

A. That's the major factor. And it's easy to understand when the rate structure is examined. The marginal tax rate is 11 percent on taxable incomes between $3,400 and $5,500, but then it rises rapidly to 22 percent on incomes above $20,200, 33 percent above $35,200, and 42 percent above $60,000. The top rate of 50 percent locks in when taxable income exceeds $162,400.

Q. *Are you saying that this is unfair, that there is too much progressivity in the Federal income tax? After all, most Americans would probably favor "ability to pay" as an income tax goal.*

A. Probably so, but ability to pay does not require so sharp an increase in tax payments as income rises. It implies, instead, that people who are better off should bear a larger share of the tax burden.

If familiar with the facts, most Americans would probably say that a family at the upper end of the middle-income range should not pay ten times the taxes of a family at the lower end. Nor would most believe that middle class Americans should be hit with a marginal tax rate of 30 percent or more.

Q. *Is there any evidence of unhappiness with the degree of progressivity?*

A. It is doubtful that the typical taxpayer realizes that it is so steep. But the growing popularity of the "flat" tax proposals — reforms that would tax income at a single, low rate — indicates a yearning for less or even no progressivity.

Bradley-Gephardt Proposal

Q. *Are you referring to the Bradley-Gephardt proposal?*

A. It is one of the entries, although it is not a pure flat tax. Bradley-Gephardt would establish a three-tier rate schedule, with a maximum of 30 percent. It is very significant that the sponsors have named their proposal "The Fair Tax," implying that the existing system is, indeed, unfair.

It is also highly significant that the sponsors are Democrats and that the plan has been endorsed widely in Democratic party circles. In the past, many Democrats have strongly supported not just ability to pay, but steep progression in income taxes.

Q. *Are they listening to different drummers today?*

A. Same drummers; different message. The drummers are their middle class constituents. They are telling their representatives that they are unhappy with the individual income tax — not just because of the whammy they receive as incomes rise, and they get hit very early on by high marginal rates of 30 percent and upwards, but for other reasons also.

Q. *Such as?*

A. The typical middle-income taxpayer is wise about the underground economy; he has had experience with the household worker, handyman, or even skilled service man who insists upon being paid in cash. He has heard of — or even participates in — barter clubs or more informal arrangements to trade services.

Also, the middle-income taxpayer believes, rightly or wrungly, that the rich avoid almost all taxes through the so-called "loopholes" that the press loves to parade before the public.

Middle-income taxpayers have had it with both the "tax evaders" and "tax avoiders."

Q. *Are you saying that "tax loopholes," or "tax expenditures," do not exist?*

A. No; simply that the really big "loopholes" inure to the benefit of those same middle-income taxpayers.

Q. *For example?*

A. The biggest facilitate middle-income *retirement, housing*, and *health*.

For *retirement*, employer contributions to workers' pension plans are tax deductible (but not taxable to the employee), as are individual contributions to Keogh's and IRA's. Interest on life insurance savings is excluded. For *homes*, both property taxes and mortgage interest are tax deductible. For *health*, employer contributions to medical plans can be deducted by the business but are not taxable to the employee.

These middle class tax loopholes add up to a whopping $115 billion per year. When the job- and growth-creating investment tax credit is added in, you have a very big portion of the so-called tax loopholes or expenditures.

Q. *Are you implying that politics militate against closing these loopholes?*

A. Definitely yes. Bradley-Gephardt and other reform plans would make a stab in that direction, but don't hold your breath. The middle class has massive political clout. For example, middle class Americans — not Wall Street or Big Business — forced Congress to slash capital gains taxes in 1978 despite strong opposition from the Carter Administration.

Q. *Do you have any other evidence of public unhappiness with income taxes?*

A. Yes. The Advisory Council on Intergovernmental Relations (ACIR) is a respected organization which polled the public last summer with this question: "Suppose your Federal, State, and local governments must raise taxes, which way would be a better way to do it?"

The answers? Fifty-two percent favored a sales tax. Only 24 percent spoke out for an income tax.

Income Taxes and Economic Goals

Q. *Are there any other problems with the income tax?*

A. Yes, there are several. Perhaps most important is its economic impact, i.e., its inherent bias against the saving and productive investment that create jobs, growth, and international competitiveness.

Q. *Why do income taxes deter saving?*

A. Because they tax saving twice, once when the income is earned and again when income on the invested savings is taxed. Moreover, our progressive rate structure results in higher taxes on those upper-income individuals who save the most.

Q. *But isn't it true that some of the tax expenditures you mentioned earlier give saving a special break?*

A. Yes, and that helps. But the fact is that such deductions fail to correct the problem entirely and even if they did, there is real question whether a proliferation of credits and deductions — which further complicate the tax system — is the right way to go.

Furthermore, the fact that taxpayers have pressured Congress to enact such "loopholes" is evidence that they believe saving and investment are too heavily taxed and that fundamental reform is needed.

Q. *How does our income tax system stack up with our foreign competitors?*

A. Our tax system hurts us in international trade. Many competitor nations rely heavily on taxes on goods, such as the value added tax (VAT). A VAT (or any other excise or sales tax) can be forgiven on exports, thereby lowering their cost to foreigners, and added to imports, thereby raising the price of imported goods.

In the U.S., neither the corporate income tax nor the employer portion of the payroll tax can be rebated on exports and added to imports. Unless relative currency values adjust efficiently, this tax differential puts U.S. producers at a serious competitive disadvantage in international markets.

Q. *Are there any other drawbacks to the corporate income tax as now structured?*

A. Yes. Most troublesome is the well-known double taxation of corporate profits. The corporation pays an income tax on its profits; so does the stockholder, on dividends paid out of those profits. The combined marginal tax rate on corporate profits and stockholder dividends can hit as high as 73 percent (46 percent at the corporate level, another 50 percent at the individual level).

Such heavy taxes lower the after-tax rate of return on investment and also reduce the cash available for such investment. That's very bad for capital formation.

Q. *What else is wrong with the corporate income tax?*

A. A political problem. Politicians can vote to raise the corporate tax and tell their individual constituents that they are not taxing them. This is not true. The corporate tax is either passed on to consumers in the form of higher prices, directly to workers in the form of lower wages, or backwards to the shareholders who put up the capital for the business.

But as long as the corporate tax exists, and as long as the press and politicians collaborate to fool the public, the temptation to raise the corporate tax will be very strong.

The 1982 tax bill (TEFRA), which raised taxes on corporations by huge amounts, but not by much on individuals, is a good case in point.

Viability of the Federal Income Tax

Q. *Earlier, you stated that viability is an important criterion for a tax system. How does the Federal income tax stack up in that respect?*

A. Not well at all. Not that the income tax is in danger of outright repeal. But it is clear that the tax is increasingly unpopular — witness the ACIR poll, which indicated by a two to one margin that taxpayers favor the sales tax over the income tax as a revenue raiser.

Q. *But isn't the sales tax regressive?*

A. Yes. Since lower-income individuals spend a larger portion of their income on goods and services than higher income individuals, the sales tax is regressive.

Q. *Then why do so many people favor it over the income tax?*

A. For three reasons.

First, they like the convenience of paying taxes at the rate of a few dollars each day, as part of their regular purchases, absent all the fuss and bother of keeping income tax records, filing returns, making estimated payments, waiting for refunds, and so on.

Second, middle-income taxpayers in particular appear to believe that they are caught in the middle. Most of the poor are exempt from income taxes. A growing number of workers take pay in cash, do not report it, and thus *evade* taxes. And, it is widely believed that the rich *avoid* most taxes through use of tax loopholes. Nobody escapes a sales tax.

Third, taxpayers like the idea that if they don't spend, they aren't taxed. A sales tax automatically exempts saving and investment.

Q. *But if tax revolts have cooled, what is the current threat to the viability of the Federal income tax?*

A. The threat is not so much a matter of its repeal, but whether the income tax can continue to be relied upon as a major source of Federal revenue, especially if such revenues must be increased significantly as part of a large deficit-reduction package.

Q. *Spell that out a little.*

A. As already noted, the individual income tax is increasingly unpopular, especially among middle-income taxpayers, and that middle class unrest is the nub of the problem. Although seldom organized into articulate pressure groups, middle class taxpayers constitute the most influential of all potential constituent groups as far as Members of Congress are concerned — the middle class has the political clout.

When this fact is understood, along with the reality that the great bulk of all tax revenues must come from the middle class (as Willie Sutton said about banks, "That's where the money is"), the importance of creating a Federal income tax structure that is generally acceptable to the middle class is apparent.

Since the income tax is in great disrepute among the middle class, its viability is open to question.

Q. *You said also that the income tax cannot be relied upon to raise the Federal revenue that might be needed for deficit reduction.*

A. Yes, and this is something that's widely recognized in Congress, especially among members of the tax-writing committees. Those expert members are convinced that there is simply not enough blood in the income tax turnip to make much of a dent in the deficit. And if the amount needed is, indeed, in the range of $100 billion per year, then increases in income taxes in that magnitude are out of the question.

For example, if revenues have to be increased by $100 billion per year through higher income taxes, individual and corporate tax rates would have to be increased by at least 25 percent. That's not politically doable.

Q. *So, what is left?*

A. Fundamental tax reform.

Tax Reform: The Fundamental Choices

Q. *Before discussing the alternative approaches to fundamental tax reform, are you assuming that sizable revenues will be raised in the process, or are you assuming revenue neutrality?*

A. You can assume either. Some approaches would easily lend themselves to revenue raising, as well as structural reform. I am assuming that sizable, new revenues will be needed.

Q. *Okay. Let's start with Bradley-Gephardt, or "The Fair Tax Act of 1983." How would it work?*

A. Bradley-Gephardt would replace the existing 16-bracket individual income tax, with rates ranging from 11 to 50 percent, with a three-bracket system with rates of 14, 26, and 30 percent. Most individual credits and deductions would be eliminated. Deductions for mortgage interest, charitable items, and several other items would be retained, but even those would apply only to the 14 percent bracket (that is, if you were in a 30 percent bracket, you would still get a deduction keyed to only 14 percent).

Capital gains would be taxed like ordinary income. The corporate tax would be reduced from 46 percent to 30 percent, but all corporate tax investment stimulants, such as the investment tax credit and accelerated depreciation, would be repealed.

Q. *Is Bradley-Gephardt a good idea?*

A. It, too, is a mixed bag. The cut in marginal rates, from a top rate of 50 percent to 30 percent, is much to be desired; that would be fundamental reform. The degree of progressivity would be cut back, but taxes would still be levied on an ability to pay basis.

Taxing capital gains as ordinary income would raise those taxes by 50 percent on upper-income taxpayers and even more on middle-income people. This is a very bad idea, and, in fact, would reverse the laudable downward trend begun in Congress in 1978. Since that time, the maximum tax on capital gains has been cut from just under 50 percent to 20 percent. Venture capital has gushed forth, the stock market has been strong, and Federal revenues paid on capital gains have not dropped, but have increased.

The recent cuts in capital gains taxes have been among the most successful tax cuts in history.

Q. *How about the corporate tax changes in Bradley-Gephardt?*

A. Some economists believe that the elimination of corporate investment incentives in Bradley-Gephardt would deal a severe blow to productive investment, job creation, and growth.

Q. *Is Bradley-Gephardt enactable?*

A. As drafted, probably not. Middle-income taxpayers will not be happy with the treatment of deductions and exemptions, especially after they read the fine print. The corporate tax changes will be very controversial. Capital gains tax increases will run into exceedingly strong opposition.

By closing "loopholes," Bradley-Gephardt would try to pick up sizable revenues which can be used for the rate reductions. But this type of revenue-raising is very controversial, and the opposing interest groups are politically powerful and savvy.

Q. *Are there other "flat tax" proposals similar to Bradley-Gephardt?*

A. Yes. The Kemp-Kasten bill would levy a single flat tax of 25 percent on individuals and 30 percent on corporations. A measure introduced by Senator DeConcini would set the flat rate at 19 percent on individuals and corporations alike.

Q. *Are these good ideas? Are they enactable?*

A. They have their good points and their bad points. Either would be very difficult to enact.

Q. *What other proposals might be viewed as fundamental tax reform?*

A. They include the Consumed Income Tax, the National Retail Sales Tax, the Value Added Tax, and the Tax on Business Transactions.

The Consumed Income Tax

Q. *What is the Consumed Income Tax?*

A. Pretty much what its name implies — the individual income tax would be adjusted so that only *consumed income* would be taxed. In other words, all saving and investment income would be exempt. Congressman Heftel has introduced this concept as legislation.

Q. *That sounds like a very good idea.*

A. It is, and, in fact, it is the way we have been going in recent years, what with the introduction of Keogh plans, Individual Retirement Accounts, interest tax exemptions, lower rates on capital gains, and so on. But the Consumed Income Tax has two very great drawbacks.

Q. *What are they?*

A. First, the Consumed Income Tax is very complicated. It wouldn't simplify the tax system; it would make it even more complex. A long transition period would be involved in implementing the plan. Second, and more importantly, it would continue to rely on the income base which, as noted, is exceedingly shaky. Incidentally, this same criticism applies to Bradley-Gephardt, Kemp-Kasten, or the DeConcini proposal.

In other words, the Consumed Income Tax would represent fundamental reform in terms of reducing the tax drag on saving and investment. But it would do little to make the tax system more viable, or especially, to improve it as a means of raising revenues for deficit reduction.

Q. *Will the Consumed Income Tax be passed by Congress?*

A. We have been moving that way in a more or less evolutionary fashion. If other fundamental reform approaches are rejected, then we shall probably continue to move toward the Consumed Income Tax.

That would be a positive step, better than no reform at all.

A National Retail Sales Tax

Q. *What are the advantages of a National Retail Sales Tax?*

A. It is very easy to administer; saving and investment income are exempt automatically; public acceptance of the tax helps assure a strong and politically stable base; and it is a powerful revenue raiser (if no exemptions were allowed, it would raise about $26 billion per point at 1984 income levels).

Q. *What are the disadvantages?*

A. State and local governments look upon taxation of retail sales as their own special preserve and wouldn't take kindly to poaching by Uncle Sam. Conservatives fear that a flat-rate sales tax would gradually be inched up by spenders in Congress.

Also, the sales tax is regressive, but that could be easily remedied or offset.

Q. *How?*

A. One of three methods: (1) Exemption of so-called necessities from the tax, but that becomes pretty complicated. (2) Differential rates as applied to basic versus luxury goods, but that's also very complicated. (3) A refundable income tax credit to offset the regressivity of the sales tax.

The last approach is the best.

Q. *Just how would the tax credit work, and has it been tried elsewhere?*

A. Last question first. Indeed, it has, in several states, and very successfully.

Here's how the tax credit would work. Assume that the sales tax is set at 10 percent. If the family poverty level (that is, spending on necessities) is $10,000 per year, then $1,000 would be the amount of the tax on necessities — the practical measure of regressivity.

For the typical family of four, a refundable income tax credit of $250 per family member (a total of $1,000) would offset the impact of the sales tax on spending for necessities.

The credit would have to be refundable — refunded in cash instead of a tax cut — to take care of those low-income families who pay no income taxes. Refundable tax credits are not new; some states use them and the existing Federal "earned income" credit is refundable.

Q. *Then a National Retail Sales Tax need not be regressive.*

A. Not in this day and age. That's a small problem, easy to fix. In fact, put that credit at $300 and phase it out as incomes rise, and a combined sales tax and income tax would be progressive.

Q. *Is a National Retail Sales Tax enactable?*

A. Let's hold that question until we talk about VAT and TBT.

The Value Added Tax (VAT) and the Tax on Business Transactions (TBT)

Q. *What is a Value Added Tax?*

A. A sales tax levied at each stage of the production process, not on gross sales or net income, but on the *value added* to the materials and supplies used in production at that stage. If the VAT is 10 percent, and a manufacturer buys supplies and materials for $1,000, processes them, and then sells the output for $3,000, the value added is $2,000 and the tax is $200.

It's that simple, and it's probably also the most popular tax in the world today. It has been instituted by every country in Western Europe. Mexico has set up a VAT. Developing countries that are modernizing their tax systems are moving to a VAT.

Q. *Then it must have something going for it.*

A. It does, indeed. It is a sturdy base, both politically and economically. It exempts saving and investment income. It is relatively easy to compute but hard to cheat against. It is stable in relation to GNP. It is rebatable on exports and can be added to imports. And it's a powerful revenue raiser.

On this last point, which is very important in light of our deficit problem, a comprehensive 10 percent VAT could raise as much as $260 billion in Federal tax revenues *per year* at 1984 income levels.

Q. *Isn't the VAT or any other sales tax inflationary?*

A. To the extent it is passed on, it would be reflected in the consumer price index. However, consumers are no worse off than under an income tax. With a sales tax, the government takes the money from you at the store. Under an income tax, the government takes the money from you *before* you go to the store.

There would be an indirect impact on cost-of-living adjustments in public and private contracts. It would be a simple matter to prevent this sort of impact in the basic legislation enacting the tax.

Q. *If a VAT is such a good idea, why haven't we already adopted one?*

A. For three reasons.

Liberals argue that the VAT is nothing more than a retail sales tax, and is, therefore, regressive, and should be avoided like the plague.

Conservatives think that the VAT is too powerful a revenue raiser. Put it in at 10 percent, they say, and the spenders in the Federal government would raise it a point at a time to fund an ever-growing Federal establishment. The VAT is, the conservatives say, a money machine.

Because the VAT would be levied at the retail level, *State and local governments* would voice a similar complaint as with the National Retail Sales Tax — it's invading their special preserve.

Q. *Can those objections be met?*

A. Yes, or perhaps "maybe" is a better answer.

The objection of State and local governments might be met by dedicating some of the additional tax receipts to increasing Federal-State revenue sharing.

An alternative approach would be to levy the tax only at the production and wholesale levels, thus exempting the value added at the retail level. This would avoid the direct entry into the State and local government preserve. This variation of a VAT has been called a Tax on Business Transactions, since it would be confined to business.

Q. *But wouldn't it still be paid, ultimately, by consumers, and, therefore, be regressive?*

A. All taxes are paid by people, sooner or later. People are consumers, and consumers are people.

But consider this: Suppose a manufacturer computes its annual tax bill on the basis of net profits and sends a check to Uncle Sam for $10,000,000. Suppose that, alternatively, this manufacturer computes its tax on the basis of value added, and the amount happens to be the same, or $10,000,000, and sends its check to Uncle Sam for that amount.

In each case, business has paid a tax to the government of $10,000,000. The tax base is different, but business still draws the check to the Federal government. Whether the businessman attempts to pass the tax on or not is determined by factors other than the form of tax — most importantly, competition.

Q. *Still, the press will say that the VAT or TBT is regressive and, therefore, unfair to people. Can you do something about that?*

A. Yes, simply institute the refundable income tax credit discussed in connection with the National Retail Sales Tax. To the extent a VAT or TBT is regressive, the tax credit will correct the situation.

Q. *How would you handle the conservatives' complaint — that a VAT or TBT or even a National Retail Sales Tax are too strong as revenue raisers, and would simply feed government spending?*

A. The only safe approach would be a Constitutional amendment to cap the VAT, TBT, or Sales Tax, or perhaps permit increases on the vote of four-fifths of the Members of each House of Congress, or whatever.

Q. *Is that likely?*

A. Stranger things have happened.

But you're right; adopting a Constitutional amendment is not easy. Still, it could be the price conservatives such as myself would demand for setting up so powerful a revenue raiser.

Q. *Can a VAT or TBT be enacted?*

A. Right now the odds are not good. Most people don't understand how this step would truly help reform the U.S. tax system. But public and Congressional conviction that significant revenues have to be raised, along with spending cuts, as part of a deficit reduction package, could set the stage for something so radical.

Q. *Why might this happen?*

A. Because revenue needs are so great and the income tax is so weak that fundamental reform may be a necessity. The key is the need for a new or supplemental tax base, one that is both economically and politically sturdy.

Q. *Do you have a plan?*

A. Yes.

Q. *I thought you would. What is it?*

A. It's very simple. Here's how it would work.

In 1985, Congress would enact a 10 percent VAT, or a National Retail Sales Tax. The tax would not be set in place immediately, but phased in over five years at two percentage points a year, thus minimizing the impact on the consumer price index. By 1990, when fully phased in, a comprehensive 10 percent VAT or National Retail Sales Tax, adjusted to remove regressivity, would raise upwards of $300 billion per year in additional revenues.

In the first two or three years, the proceeds of the new tax would be used primarily to reduce the budget deficit and even turn it into a small surplus.

In the later years of the phase-in, the additional revenues would be used to move *toward* — *toward*, not to — a flat tax, perhaps along the lines of the rate schedules in Bradley-Gephardt, with maximum rates of 30 percent on individuals and corporations alike. With additional revenues to spread around in rate cuts, Bradley-Gephardt would not have to fight for the loophole-closing that is politically difficult, if not impossible.

The legislation establishing the consumption tax could also provide for a Constitutional amendment that would limit increases in the original rate.

Q. *Would this Constitutional amendment be sufficient to gain conservative support for a major deficit-reduction package?*

A. Probably not. Several other things might be necessary.

Spending restraint would have to account for a reasonable portion — at least 50 percent — of the total package. In addition, experience with the 1982 tax increase raises real questions as to whether any tax increase would, indeed, go to reduce the deficit, or whether it would simply go to support additional Federal spending.

I wouldn't be at all surprised if conservatives, therefore, insisted on a couple of other provisions in the Constitutional amendment. One might be some version of the Balanced Budget/Tax Limitation Amendment that passed the Senate (but not the House) in 1982. The other might be a limitation on Federal spending relative to gross national product, say, at 21 percent or so.

Q. *But why would liberals go along?*

A. They would get a powerful new tax to fund their social programs — in fact, this advantage caused socialists and laborites to support the adoption of value added taxes in Scandinavia in the 1950's.

There may be a pretty good deal to be cut between conservatives and liberals.

Q. *Where would it all end up?*

A. According to this scenario, by some time in the 1990's we would have a welcome surplus in the Federal budget and a tax system that is economically sensible and politically viable. It would consist of three legs: a payroll tax, on both employers and employees; an income tax, but with marginal rates reduced and vertical equity improved; and a full-fledged consumption tax, whether a VAT, TBT, or a National Retail Sales Tax.

Q. *That's pretty ambitious. Is it — or something like it — likely to happen?*

A. Not unless people, the press and politicians talk about the problem, exchange ideas, explode the myths, explore alternatives.

In short, if there is a true national dialogue, then fundamental tax reform may have a shot.

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ACCF: Center for Policy Research

Special Report

Congressional Proposals for Fundamental Tax Reform: A Comparison

Margo Thorning*

Introduction

Even as the ink has not yet dried on the 1984 tax bill, there is a consensus among Members of Congress, the Reagan Administration and Democratic Presidential candidate Walter Mondale, and tax policy experts that another tax bill will be forthcoming next year. The time may even be right in 1985 for fundamental tax reform as opposed to the tinkering with the basic income tax structure in the last decade. President Reagan has commissioned the Treasury Department to submit a tax reform and simplification study to him by the end of the year. The issue is part and parcel of the 1984 political campaigns. The Brookings Institution, among other public policy think tanks, has called for fundamental tax overhaul. This year, the media's normal April 15 tax filing stories have found greater public frustration with the current income tax system than before and in-depth coverage of alternatives now appears on a regular basis. And significantly, there are more proposals in Congress on tax reform and simplification.

This special report compares the fundamental tax restructuring proposals pending in Congress. First, they are categorized as either income or expenditure taxes. Second, each proposal is described, including the major features affecting individuals and business, tax rates for individuals and business, and the revenue effects of the legislation. The author referred to fact sheets and the legislation itself, and consulted with Congressional staffs, tax attorneys and accountants in preparing this paper. Several of the proposals were ambiguous as to specific provisions and this paper incorporates the terminology used in the legislation to ensure accuracy. The proposals do not refer to identical concepts of income and expenditure; therefore, tax rate comparisons must be made with care. Any errors, however, are solely attributable to the author.

Section I of this special report compares the following income tax systems:

- *"The Fair Tax Act of 1983" (S. 1472, H.R. 3271), introduced by Senator Bill Bradley (D-NJ) and Representative Richard A. Gephardt (D-MO);*
- *"The Fair and Simple Tax Act" (S. 2600, H.R. 5533), introduced by Senator Robert Kasten (R-WI) and Representative Jack Kemp (R-NY);*
- *"The SELF Tax Plan Act" (S. 1040), introduced by Senator Dan Quayle (R-IN); and*
- *"The Ten Percent Flat Rate Tax Act" (H.R. 5432), introduced by Representative Mark Siljander (R-MI).*

Section II compares the following expenditure tax systems:

- *"The Progressive Consumption Tax" (H.R. 5841), introduced by Representative Cecil Heftel (D-HI), and*
- *"The Flat Rate Tax Act" (S. 557), introduced by Senator Dennis DeConcini (D-AZ).*

Section III lists other tax reform proposals pending in Congress, as of May 23, 1984.

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*The author, Dr. Margo Thorning, is Director of Research of the ACCF: Center for Policy Research. The analysis should not be construed to be an endorsement of any specific tax restructuring option. This special report on the tax reform proposals pending in Congress is one of a series of papers on capital formation issues published by the ACCF: Center for Policy Research to further public debate on economic policy.

I. INCOME TAX SYSTEMS				II. EXPENDITURE TAX SYSTEMS	
A. Bradley-Gephardt "FAIR"	B. Kemp-Kasten "FAST"	C. Quayle "SELF"	D. Siljander "FLAT 10"	A. Heftel "PCT"	B. DeConcini "FLAT"
DESCRIPTION	DESCRIPTION	DESCRIPTION	DESCRIPTION	DESCRIPTION	DESCRIPTION
"The Fair Tax Act of 1983" (S. 1472, H.R. 3271), introduced by Senator Bill Bradley (D-NJ) and Representative Richard A. Gephardt (D-MO), broadens the income tax base by eliminating or limiting many of the special provisions in current law (e.g., tax credits, deductions, exclusions and the like) for both individuals and corporations. "The Fair Tax Act" (FAIR) is a tax on income, rather than on expenditures; it has a progressive rate structure, with rates ranging from 14 to 30 percent for individuals. FAIR does not provide for income tax indexing. (Under current law, the income tax brackets, zero bracket amount, and personal exemption will be adjusted for increases in the consumer price level starting in 1985.) FAIR reduces the maximum corporate tax rate from 46 percent to 30 percent.	"The Fair and Simple Tax Act" (S. 2600, H.R. 5533), introduced by Senator Robert Kasten (R-WI) and Representative Jack Kemp (R-NY), broadens the individual tax base by eliminating or limiting many of the special provisions in current law (e.g., tax credits, deductions, exclusions and the like) for both individuals and corporations. Subsequent to the introduction of S. 2600 and H.R. 5533, Senator Kasten and Representative Kemp modified their proposal; these changes are incorporated in the analysis. "The Fair and Simple Tax" (FAST) is a tax on income, rather than on expenditures; it levies a tax rate of 25 percent on the taxable income of individuals but provides an employment (wage and salary) income exclusion. The employment income exclusion is designed to offset the social security payroll tax. FAST indexes the personal exemption, zero bracket amount, employment income exclusion, and capital gains for inflation. FAST reduces the maximum corporate tax rate from 46 percent to 30 percent; a 15 percent tax rate is levied on corporate income up to $50,000.	"The SELF Tax Plan Act" (S. 1040), introduced by Senator Dan Quayle (R-IN), broadens the individual income tax base by eliminating or limiting many of the special provisions in current law (e.g., tax credits, deductions, exclusions and the like) for both individuals and corporations. Subsequent to the introduction of S. 1040, Senator Quayle modified his proposal; these changes are incorporated in the analysis. "The SELF Tax Plan" (SELF) is a tax on income, rather than on expenditures; it has a progressive rate structure, with rates ranging from 15 to 30 percent for individuals. SELF retains the individual income tax indexing provisions scheduled to go into effect in 1985. SELF reduces the maximum corporate tax rate from 46 percent to 30 percent.	"The Ten Percent Flat Rate Tax Act" (H.R. 5432), introduced by Representative Mark Siljander (R-MI), broadens the tax base by eliminating or limiting many of the special provisions in current law (e.g., tax credits, deductions, exclusions and the like) for individuals. "The Ten Percent Flat Rate Tax Act" (FLAT 10) becomes effective three years after its passage and provides a general amnesty for delinquent taxpayers during the transition period. Tax revenues collected during the general amnesty are used to offset the revenue shortfall which FLAT 10 may incur. FLAT 10 is a tax on income, rather than on expenditures; it has a flat 10 percent tax rate. FLAT 10 indexes the personal exemption for inflation. FLAT 10 makes no revisions to the current law corporate tax system.	"The Progressive Consumption Tax" (H.R. 5841), introduced by Representative Cecil Heftel (D-HI), substitutes a consumed income tax, also known as a cash flow expenditure tax, for the current income tax system. "The Progressive Consumption Tax" (PCT) is a tax on income consumed, rather than on income received. PCT eliminates or modifies many of the special provisions in current law (e.g., tax credits, deductions, exclusions and the like) for both individuals and corporations. The tax base consists of all monetary receipts, including borrowed funds, minus any verifiable saving, investment, or debt repayment. PCT has a progressive rate structure with rates ranging from 10 percent to 50 percent. PCT does not provide for tax indexing. PCT replaces the current corporate income tax with a 30 percent tax on corporate dividend payments to stockholders.	"The Flat Rate Tax Act" (S. 557), introduced by Senator Dennis DeConcini (D-AZ), substitutes an expenditure tax for the current income tax system. "The Flat Rate Tax Act" (FLAT) is almost identical to the tax reform plan proposed by Drs. Robert E. Hall and and Alvin Rabushka, The Hoover Institution, Stanford University. FLAT eliminates or modifies many of the special provisions in current law (e.g., tax credits, deductions, exclusions and the like) for both individuals and corporations. FLAT allows no deduction for net saving, but no tax is due when savings and investment income are withdrawn and consumed. Under FLAT, the tax on consumption from savings is eliminated, because it is paid at the time the income is earned. FLAT integrates the individual and corporate income taxes; therefore, all income received by individuals from business has already been taxed and is exempt from the individual income tax. FLAT taxes both individual and business income at a 19 percent rate. Under FLAT, the personal exemption is indexed for inflation.

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MAJOR FEATURES FOR INDIVIDUALS 1. FAIR increases the personal exemption from $1,000 per person, under current law, to $1,600 per taxpayer and spouse. Dependents receive a $1,000 exemption, and the elderly and the blind receive an additional $1,000 exemption, as current law provides. The zero bracket amount increases from $2,300 to $3,000, for individuals, and from $3,400 to $6,000, for joint returns. As a result of these changes, a family of four pays no Federal income tax until adjusted gross income exceeds $11,200. Under current law, a family of four with all income from labor pays Federal income tax for calendar year 1984 when adjusted gross income exceeds $8,936. 2. FAIR eliminates most special tax provisions for individuals. Significant ones are: • State and local tax deductions (except income and real property); • Two earner deduction; • Dividend exclusion; • Medical insurance and group term life insurance premiums paid by the employer and nontaxable to the employee; and • Capital gains exclusion. (FAIR increases the maximum tax rate on individual capital gains from the current 20 percent to 30 percent. Some taxpayers not at the maximum rate under current law face even greater increases in marginal tax rates on capital gains. FAIR also eliminates the distinction between short-term and long-term capital gains.) 3. FAIR retains several special tax provisions for individuals. Significant ones are: • Home mortgage interest deduction; • State and local income (Continued on page 4)	**MAJOR FEATURES FOR INDIVIDUALS** 1. FAST increases the personal exemption from $1,000 per person, under current law, to $2,000. The elderly and the blind do not receive an additional personal exemption, as current law provides. The zero bracket amount increases from $2,300 to $2,700, for individuals, and from $3,400 to $3,500, for joint returns. FAST also allows a 20 percent exclusion for employment income. As a result of these changes, a family of four pays no Federal income tax until adjusted gross income exceeds $14,375. Under current law, a family of four with all income from labor pays Federal income tax for calendar year 1984 when adjusted gross income exceeds $8,936. 2. FAST eliminates most special tax provisions for individuals. Significant ones are: • State and local tax deductions (except real property); • Two earner deduction; • Dividend exclusion; and • Capital gains exclusion. (FAST taxes capital gains in full; capital losses are deductible in full and without limit; the basis of a capital asset is indexed for inflation. However, during a ten-year transition period, taxpayers may choose between an exclusion of 25 percent of net capital gains or indexation of basis.) 3. FAST retains several special tax provisions for individuals. Significant ones are: • Home mortgage interest deduction; • Personal interest deduction; • Real property tax deduction; (Continued on page 4)	**MAJOR FEATURES FOR INDIVIDUALS** 1. SELF retains the $1,000 per person personal exemption under current law. The elderly and the blind do not receive an additional exemption, as current law provides. The zero bracket amount increases from $2,300 to $6,000, for individuals, and from $3,400 to $10,000, for joint returns. As a result of these increases, a family of four pays no Federal income tax until adjusted gross income exceeds $14,000. Under current law, a family of four with all income from labor pays Federal income tax for calendar year 1984 when adjusted gross income exceeds $8,936. 2. SELF eliminates most special tax provisions for individuals. Significant ones are: • Personal interest deductions; • State and local tax deductions for property, income, and other taxes; • Dividend exclusion; • Earned income credit; • Homeowner exclusion of up to $125,000 of the gain on the sale of a residence by taxpayers age 55 and older; • Medical insurance and group term life insurance premiums paid by the employer and nontaxable to the employee; and (Continued on page 4)	**MAJOR FEATURES FOR INDIVIDUALS** 1. FLAT 10 increases the personal exemption from $1,000 per person, under current law, to $2,000. The elderly and the blind receive an additional $2,000 personal exemption; current law provides an additional $1,000 exemption. FLAT 10 eliminates the zero bracket deduction. As a result of these changes, a family of four pays no Federal income tax until adjusted gross income exceeds $8,000. Under current law, a family of four with all income from labor pays Federal income tax for calendar year 1984 when adjusted gross income exceeds $8,936. 2. FLAT 10 eliminates most special tax provisions for individuals. Significant ones are: • Two earner deduction; • Dividend exclusion; • Homeowner exclusion of up to $125,000 of the gain on the sale of a residence by taxpayers age 55 and older; • Medical expense deduction (Current law allows a deduction for expenses above 5 percent of adjusted gross income.); and • Capital gains exclusion. 3. FLAT 10 retains several special tax provisions for individuals. Significant ones are: (Continued on page 4)	**MAJOR FEATURES FOR INDIVIDUALS** 1. PCT eliminates the personal exemption and the zero bracket deduction. PCT provides a credit of $200 for each taxpayer and dependent. 2. PCT eliminates most special tax provisions for individuals. Significant ones are: • State and local tax deductions (except income); • Two earner deduction; • Homeowner exclusion of up to $125,000 of the gain on the sale of a residence by taxpayers age 55 and older; and • Capital gains exclusion. 3. PCT retains several special tax provisions for individuals. Significant ones are: • Home mortgage interest deduction; • State and local income tax deduction; • Charitable contribution deduction; and • Certain medical expense deductions. 4. PCT substantially modifies several special tax provisions for individuals, including: • IRA and Keogh deductions. (IRAs and Keoghs are expanded so that any verifiable saving or investment is ex- (Continued on page 4)	**MAJOR FEATURES FOR INDIVIDUALS** 1. FLAT increases the personal exemption for single taxpayers from $1,000 to $4,100. Married couples filing jointly receive a $6,700 exemption; each dependent receives an exemption of $810. The elderly and the blind do not receive an additional personal exemption, as current law provides. There is no zero bracket in FLAT. As a result of these changes, a family of four pays no Federal income tax until adjusted gross income exceeds $8,320. Under current law, a family of four pays Federal income tax for calendar year 1984 when adjusted gross income exceeds $8,936. 2. FLAT eliminates most special tax provisions for individuals. Significant ones are: • Home mortgage interest deduction; • Personal interest deduction; • State and local tax deductions; • Two earner deduction; • Homeowner exclusion of up to $125,000 of the gain on the sale of a residence by taxpayers age 55 and older; • Charitable contribution deduction; and • Medical expense deduction. (Current (Continued on page 4)

I. INCOME TAX SYSTEMS				II. EXPENDITURE TAX SYSTEMS	
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MAJOR FEATURES FOR INDIVIDUALS *(Continued from page 3)* tax and real property deductions; • Charitable contribution deduction; • Individual Retirement Accounts (IRA) and Keogh deductions; • General obligation bond interest deduction; • Earned income credit; and • Social security benefit exemption for low and moderate income individuals. **4.** FAIR substantially modifies several special tax provisions for individuals. Significant ones are: • Homeowner exclusion of up to $125,000 of the gain on the sale of a residence by a taxpayer age 55 and older (retained for computing FAIR's base tax but not the surtax); • Personal interest deductions (FAIR allows nonbusiness interest deductions, other than home mortgage interest, only to the extent that the amount does not exceed the net investment income of the taxpayer for the taxable year); and • Medical expense deduction. [Expenses above 10 percent of adjusted gross income (AGI) are deductible. Current law allows a deduction for expenses above 5 percent of AGI.] **5.** FAIR substantially reduces the value of retained special tax provisions compared to current law. Personal exemptions, exclusions and standard or itemized deductions offset taxable income only at the taxpayer's basic rate of 14 percent. (For example, under FAIR, a $100 mortgage interest deduction is worth only $14, compared to up to $50 under current law.)	**MAJOR FEATURES FOR INDIVIDUALS** *(Continued from page 3)* • Charitable contribution deduction; • IRA and Keogh deductions; • General obligation bond interest deduction; • Earned income credit (slightly modified); • Homeowner exclusion of up to $125,000 of the gain on the sale of a residence by taxpayers age 55 and older; and • Social security benefit exemption for low and moderate income individuals. **4.** FAST substantially modifies several special tax provisions for individuals, including: • Medical expense deduction. [Expenses above 10 percent of adjusted gross income (AGI) are deductible. Current law allows a deduction for expenses above 5 percent of AGI.] **5.** FAST allows a 20 percent exclusion for employment income; up to about $40,000, 20 percent of employment income is excluded from tax. The exclusion is gradually phased out as employment income increases to a level of about $100,000. For taxpayers with employment income below $10,000, all gross income below $10,000 qualifies for the exclusion.	**MAJOR FEATURES FOR INDIVIDUALS** *(Continued from page 3)* • Capital gains exclusions. (SELF increases the maximum tax rate on individual capital gains from the current 20 percent to 30 percent. Some taxpayers not at the maximum rate under current law face even greater tax increases in marginal tax rates on capital gains.) **3.** SELF retains several special tax provisions for individuals. Significant ones are: • Home mortgage interest deduction; • Charitable contribution deduction; • IRA and Keogh deductions; • General obligation bond interest deduction; • Medical expense deduction (Current law allows a deduction for expenses above 5 percent of adjusted gross income.); and • Social security benefit exemption for low and moderate income individuals.	**MAJOR FEATURES FOR INDIVIDUALS** *(Continued from page 3)* • Home mortgage interest deduction, • Personal interest deduction; • State and local tax deductions for property, income, and other taxes; • Charitable contribution deduction; • IRA and Keogh deductions; • General obligation bond interest deduction; and • Social security benefit exemption for low and moderate income individuals.	**MAJOR FEATURES FOR INDIVIDUALS** *(Continued from page 3)* cluded from taxable income, including contributions to the social security retirement system.) **5.** PCT defines taxable income to include all receipts minus saving and debt repayment. Significant ones are: • All receipts included under present law; • All realized capital gains; • All interest and dividends; • Social security payments; • Gifts and bequests; and • All borrowed money (except for home mortgages).	**MAJOR FEATURES FOR INDIVIDUALS** *(Continued from page 3)* law allows a deduction for expenses above 5 percent of adjusted gross income.) **3.** FLAT retains several special tax provisions for individuals, including: • Medical insurance and group term life insurance premiums paid by the employer and nontaxable to the employee. **4.** FLAT substantially modifies several special tax provisions for individuals, including: • IRA and Keogh earnings. (All dividends, interest, or capital gains received on a taxpayer's savings are exempt from tax.)

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MAJOR FEATURES FOR BUSINESS	**MAJOR FEATURES FOR BUSINESS**	**MAJOR FEATURES FOR BUSINESS**	**MAJOR FEATURES FOR BUSINESS**	**MAJOR FEATURES FOR BUSINESS**	**MAJOR FEATURES FOR BUSINESS**
1. FAIR retains the current distinction between corporate and other forms of business. **2.** FAIR eliminates most special tax provisions for corporations. Significant ones are: • Investment Tax Credit; • Accelerated Cost Recovery System (ACRS) (FAIR replaces ACRS with a new depreciation system. Business assets owned by corporations and by individuals are grouped according to their expected useful lives established under the old Asset Depreciation Range (ADR) system and depreciated using the 250 percent declining balance method. These new class lives result in a substantial increase in the period over which most long-lived assets are depreciated.); • Research and Development Credit; • Domestic International Sales Corporations (Foreign Sales Corporations); • Controlled Foreign Corporation income tax deferral; • Percentage depletion, expensing of exploration and development costs, and the intangible drilling cost deduction Continued on page 6)	**1.** FAST retains the current distinction between corporate and other forms of business. **2.** FAST eliminates most special tax provisions for corporations. Significant ones are: • Investment Tax Credit; • Research and Development Credit; • Domestic International Sales Corporations (Foreign Sales Corporations); and • Percentage depletion, expensing of exploration and development costs, and the intangible drilling cost deduction. (FAST depreciates these costs rather than allowing expensing.) **3.** FAST retains several special tax provisions for corporations. Significant ones are: • Accelerated Cost Recovery System; • Foreign tax credit; and • Controlled Foreign Corporation income tax deferral. **4.** FAST substantially modifies several special tax provisions for corporations. Significant ones are: • Treatment of small business (FAST levies a 15 percent tax rate on cor- Continued on page 6)	**1.** SELF retains the current distinction between corporate and other forms of business. **2.** SELF modifies most special tax provisions for corporations. SELF adheres to the following principles: • Elimination of special corporate tax provisions which favor specific industries; • Revision of depreciation rules so that industries utilizing short-lived assets receive no advantage over those using long-lived assets; and • Retention of deductions for ordinary business expenses, including interest payments. **3.** SELF moves toward eliminating the double tax on corporate income by providing a deduction to the corporation for dividend payments to stockholders.	**1.** FLAT 10 makes no revisions to the current corporate tax system.	**1.** PCT retains the current distinction between corporate and other forms of business. **2.** PCT eliminates all special tax provisions for corporations, because tax liability is computed only on the difference between a corporation's profits and what it invests. In other words, only dividends paid to stockholders are subject to the corporate tax. To insure that closely held corporations do not serve as devices for avoiding personal taxes, a minimum tax is levied on those corporations retaining more than 50 percent of their income.	**1.** FLAT eliminates the current distinction between corporate and other forms of business. **2.** FLAT eliminates most special tax provisions for business. Significant ones are: • Accelerated Cost Recovery System (ACRS) (FLAT replaces ACRS with expensing.); • Research and Development Credit; • Domestic International Sales Corporations (Foreign Sales Corporations); • Interest payment deductions; • Percentage depletion; and • Foreign tax credit. **3.** FLAT retains several special tax provisions for business. Significant ones are: • Cost of goods, services, and materials, whether or not resold during the year; • Market value of business inputs brought into the United States; • Controlled Foreign Corporation income tax deferral; • Actual cost of travel and entertainment expenses for business purposes; and • Expensing of exploration and development costs and the intangible drilling cost deduction. **4.** FLAT substantially modifies several special tax provisions for business. Significant ones are: • Loss carryforwards (FLAT permits Continued on page 6)

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MAJOR FEATURES FOR BUSINESS *(Continued from page 5)* allows depreciation of these costs rather than expensing); and • Corporate capital gains. (The corporate capital gains tax rate increases from 28 percent to 30 percent.) 3. FAIR retains several special tax provisions for corporations, including: • The foreign tax credit.	**MAJOR FEATURES FOR BUSINESS** *(Continued from page 5)* porate income up to $50,000. Corporations, sole proprietors, and partnerships may expense up to $10,000 of business investments each year.); and • Corporate capital gains. (FAST decreases the corporate capital gains tax rate from 28 percent, under current law, to 20 percent.)	**MAJOR FEATURES FOR BUSINESS**	**MAJOR FEATURES FOR BUSINESS**	**MAJOR FEATURES FOR BUSINESS**	**MAJOR FEATURES FOR BUSINESS** *(Continued from page 5)* losses to be carried forward with no time limitation.); • Dividends received (FLAT excludes from taxation all dividends received.); and • Capital gains. (FLAT excludes from taxation all capital gains on securities.)
TAX RATE FOR INDIVIDUALS 1. FAIR has a progressive rate structure for individuals. Taxable income (adjusted gross income minus all deductions, exclusions, and exemptions) is subject to a 14 percent tax rate. 2. FAIR also levies a surtax on adjusted gross incomes exceeding $25,000 for single returns and $40,000 for joint returns. FAIR's rate schedule is shown on the opposite page.	**TAX RATE FOR INDIVIDUALS** 1. FAST levies a 25 percent rate on all taxable income. However, 20 percent of employment income under the social security wage base (currently almost $40,000) is excluded from the tax base. For taxpayers with employment income above $40,000, the excluded employment income is added back at a 12.5 percent rate, as income rises. The exclusion is phased out entirely at an income of $100,000 and above. All investment income is taxed at a 25 percent rate. If a taxpayer's total employment income is below $10,000 ($20,000 on a joint return), all gross income, including investment income, below $10,000 ($20,000 on a joint return), qualifies for the 20 percent employment credit. FAST's rate schedule is shown on the opposite page.	**TAX RATE FOR INDIVIDUALS** 1. SELF has a progressive rate structure for individuals. The tax rates are shown on the opposite page.	**TAX RATE FOR INDIVIDUALS** 1. FLAT 10 levies a 10 percent tax on adjusted gross income.	**TAX RATE FOR INDIVIDUALS** 1. PCT imposes taxes ranging from 10 percent on the first $1,000 of taxable consumption to 50 percent on taxable consumption over $72,000 per year for single returns. Taxable consumption is adjusted gross consumption minus the allowed tax preferences. Adjusted gross consumption is the sum of net income, borrowing and any withdrawal from saving for the taxable year *minus* repayment of debt and any increase in saving for the taxable year. Joint returns are taxed at 10 percent on the first $2,100 of taxable consumption to 50 percent on taxable consumption over $96,000.	**TAX RATE FOR INDIVIDUALS** 1. FLAT levies a 19 percent tax on the difference between a taxpayer's compensation and his personal exemptions. Compensation is the sum o wages, pensions, bonuses, awards, the cash equivalent of financial benefits provided by an employer, and workman's compensation.

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TAX RATE FOR BUSINESS 1. FAIR levies a 30 percent tax rate on all corporations, a reduction from the maximum 46 percent rate under current law. FAIR eliminates the corporate minimum tax.	**TAX RATE FOR BUSINESS** 1. FAST levies a 30 percent tax rate on corporations, a reduction from the maximum rate of 46 percent under current law. Corporations pay 15 percent on income up to $50,000. FAST retains the corporate minimum tax.	**TAX RATE FOR BUSINESS** 1. SELF levies a 30 percent tax rate on all corporations, a reduction from the maximum 46 percent rate under current law. SELF retains the corporate minimum tax.	**TAX RATE FOR BUSINESS** 1. FLAT 10 makes no revisions to the maximum corporate tax rate of 46 percent under current law.	**TAX RATE FOR BUSINESS** 1. PCT levies a tax of 30 percent on corporate dividend payments to stockholders. The PCT retains a corporate minimum tax.	**TAX RATE FOR BUSINESS** 1. FLAT levies a 19 percent tax on business taxable income. A "business" is defined as a corporation, proprietorship, or partnership. FLAT eliminates the corporate minimum tax.
REVENUE EFFECTS 1. FAIR is designed to raise the same amount of revenue as our current Federal tax system. It is also designed to raise approximately the same amount of revenue from each income class as under current law. Joint Committee on Taxation estimates indicate that FAIR raises the same amount of revenue as under current law.	**REVENUE EFFECTS** 1. FAST is designed to raise the same amount of revenue as our current Federal tax system. It is also designed to raise the same amount of revenue from each income class as under current law. Joint Committee on Taxation revenue estimates on the revised version of FAST are not yet available.	**REVENUE EFFECTS** 1. SELF is designed to raise the same amount of revenue from the individual income tax as the current Federal income tax system. It is also designed to raise approximately the same amount of revenue from each income class as under current law. The corporate income tax may yield less revenue than the current Federal tax system. Joint Committee on Taxation revenue estimates on SELF are not yet available.	**REVENUE EFFECTS** 1. FLAT 10 is designed to raise approximately the same amount of revenue as our current Federal tax system. Joint Committee on Taxation revenue estimates on FLAT 10 are not yet available.	**REVENUE EFFECTS** 1. PCT is designed to raise the same amount of revenue as our current Federal tax system. Joint Committee on Taxation revenue estimates on PCT are not yet available.	**REVENUE EFFECTS** 1. FLAT is designed to raise the same amount of revenue as our current Federal tax system. Joint Committee on Taxation revenue estimates on FLAT are not yet available.

A. BRADLEY-GEPHARDT "FAIR" TAX RATE SCHEDULE FOR INDIVIDUALS

Single Returns

Income	Surtax Rate	Combined Marginal Tax rate[2]
Taxable Income	0	14 percent
Adjusted Gross Income[1]		
Below $25,000[3]	No Surtax	14 percent
$25,000 to $37,500	12 percent	26 percent
Over $37,500	16 percent	30 percent
Joint Returns		
Taxable Income	0	14 percent
Adjusted Gross Income[1]		
Below $40,000[3]	No Surtax	14 percent
$40,000 to $85,000	12 percent	26 percent
Over $85,000	16 percent	30 percent

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[1] Current law defines adjusted gross income as the sum of: Wages and salaries; Interest income; Dividends; Refunds of state and local income taxes; Alimony received; Business income; Capital gains; Taxable pensions; Rents; Royalties; Farm income; Unemployment compensation; and Other income minus: Moving expenses; Employee business expenses; IRA and Keogh payments; Alimony paid; Two earner deduction; and Other items.

[2] The combined marginal tax rate consists of the 14 percent tax on taxable income and the surtax on adjusted gross income above $25,000 (single returns) and $40,000 (joint returns).

[3] A single taxpayer pays no tax until adjusted gross income exceeds $4,800; a family of four pays no tax until adjusted gross income exceeds $11,200.

B. KEMP-KASTEN "FAST" TAX RATE SCHEDULE FOR INDIVIDUALS

Employment Income	Marginal Tax Rate
Single Returns	
Below $39,300[1]	20 percent
$39,300 to $102,000	28 percent
Over $102,000[1]	25 percent
Investment Income	25 percent
Joint Returns[2]	
Below $39,300[1]	20 percent
$39,300 to $102,000	28 percent
Over $102,000	25 percent
Investment Income	25 percent

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[1] Under FAST, a single taxpayer does not pay tax until adjusted gross income exceeds $5,675; a family of four pays no tax until adjusted gross income exceeds $14,275.

[2] The estimate assumes that employment income reported on the joint return is less than or equal to $39,300. If both spouses have employment income and the combined total exceeds $39,300, both are eligible for the 20 percent employment income exclusion.

C. QUAYLE "SELF" TAX RATE SCHEDULE FOR INDIVIDUALS

Taxable Income[1]	Marginal Tax Rate
Single Returns	
Below $20,000[1]	15 percent
$20,000 to $29,999	24 percent
Over $30,000	30 percent
Joint Returns	
Below $24,000[1]	15 percent
$24,000 to $44,999	24 percent
Over $45,000	30 percent

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[1] Taxable income is defined by the Internal Revenue Service as adjusted gross income (see footnote 1 of "FAIR" tax rate schedule for individuals) minus deductions and exemptions. In the SELF tax tables, however, personal exemptions are not included. Therefore, a single taxpayer pays no tax until adjusted gross income exceeds $7,300, and a family of four pays no tax until adjusted gross income exceeds $14,300.

III. OTHER TAX REFORM PROPOSALS PENDING IN CONGRESS (as of May 23, 1984)

Bill Number	Sponsor	Type of Tax	Tax Rate	
			Individual	Corporate
H.R. 170	Representative George Hansen (R-ID)	Income Tax	15 percent	N/A
H.R. 542	Representative Philip M. Crane (R-IL)	Income Tax	10 percent	N/A
H.R. 1770	Representative David Dreier (R-CA)	Income Tax	14 percent	N/A
H.R. 2520	Representative Leon E. Panetta (D-CA)	Income Tax	18 percent	18 percent
H.R. 3516	Representative Don Young (R-AK)	Income Tax	15 percent	N/A
S. 1767	Senator George J. Mitchell (D-ME)	Income Tax	12 – 36 percent	N/A
S. 2158	Senator Mark O. Hatfield (R-OR)	Income Tax	6 – 30 percent	N/A
H.R. 4776	Representative James H. Quillen (R-TN)	Income Tax	10 percent	N/A
H.R. 4871	Representative William E. Dannemeyer (R-CA)	Income Tax	Not greater than 15 percent	Not greater than 15 percent
H.R. 5484	Representative Ron Paul (R-TX)	Income Tax	10 percent	N/A
H.R. 5711	Representative Richard C. Shelby (D-AL)	Consumption Tax	19 percent	19 percent

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August 21, 1984

Addendum to Kemp-Kasten "FAST"

Subsequent to the publication of the Special Report, "Congressional Proposal for Fundamental Tax Reform: A Comparsion," Senator Robert Kasten and Representative Jack Kemp reintroduced their tax reform proposal (FAST), as S. 2948, H. R. 6165. The new version of FAST retains the rate structure and major provisions of the first version but makes several important changes listed below.

1. FAST now provides a $2,000 per person exemption and additional exemptions of $2,000 for the elderly and the blind. The first version of FAST has a $2,000 per person exemption but no additional exemption for the elderly and the blind. (Current law provides an additional $1,000 exemption for the elderly and the blind).

2. FAST now eliminates the consumer interest expense deduction except for home mortgages and loans for educational purposes. The first version of FAST permits the deduction of all types of consumer interest expense. (Current law permits the deduction of all types of consumer interest expense.)

3. FAST now eliminates the capital loss deduction limitation over a ten year period and subjects capital losses to the alternative minimum tax. The first version of FAST eliminates the capital loss deduction immediately and does not subject capital losses to the alternative minimum tax. (Current law limits the capital loss deduction to $3,000 per year and does not subject capital losses to the alternative minimum tax.)

4. FAST now substantially modifies certain social security provisions. First, the reduction in benefits when income earned exceeds $6,960 per year is phased out by cutting the benefit reduction from 50 to 25 cents on a dollar immediately and to zero after five years. Second, the social security benefit exemption for low and moderate income individuals is retained; marginal tax rates on social security benefits for higher income individuals are reduced. The first version of FAST retains the current law exemption from taxation of social security benefits for low and moderate income individuals but does not address the reduction in benefits occuring when income earned exceeds $6,960 per year or the high marginal tax rates faced by social security recipients whose modified adjusted gross income exceeds $25,000 ($32,000 for joint returns). (Current law reduces social security benefits by 50 cents for every dollar earned above $6,960 per year for those aged 65 to 70. In addition, a taxpayer whose modified adjusted gross income exceeds $25,000 per year ($32,000 for joint returns) is required to add 50 cents in social security benefits to his tax base for every dollar earned above the income threshold.)

5. FAST now permits taxpayers filing a joint return to exclude 20 percent of all gross income below $15,000 from tax base. The first version of FAST permits taxpayers filing a joint return to exclude 20 percent of all gross income below $20,000 from the tax base. (Current law does not permit this exclusion.)

The CHAIRMAN. Let me start with Senator Long. Do you have questions?

Senator LONG. No, I will pass, Mr. Chairman.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. Mr. Kurtz, what is your definition of a consumption tax?

Mr. KURTZ. It can take various forms, but a tax on consumption allows deductions for, or does not tax savings and does include borrowings in the tax base.

Senator PACKWOOD. Would a value-added tax be a consumption tax?

Mr. KURTZ. Yes.

Senator PACKWOOD. Windfall profits tax?

Mr. KURTZ. It is a selective excise tax.

Senator PACKWOOD. Isn't that a consumption tax?

Mr. KURTZ. It is a narrow based consumption tax.

Senator PACKWOOD. And to whom are the costs of that tax passed along?

Mr. KURTZ. The value-added tax? The consumers.

Senator PACKWOOD. So, what I am curious about is in your statement, and I am always stunned by this. When we passed the windfall profits tax, it is not a tax on the profits of oil companies. It is an excise tax. You pay it whether or not your company makes a profit. You pay if your company is going bankrupt.

Mr. KURTZ. I think that is correct. Yes.

Senator PACKWOOD. And you pass it along to everybody who eats carrots or drives a car or heats their home, and yet there was never any public outcry about that tax. In fact, your administration overwhelmingly pushed it and supported it. By and large, most liberal newspapers supported it. Why?

Mr. KURTZ. As you know, I was primarily in an administrative position, not in a policy position. But I think there was another element—it seems to me, to raise the price of oil in order to limit consumption.

Senator PACKWOOD. Wasn't also the common assumption among the public that this was a tax on oil company profits?

Mr. KURTZ. I don't know that. I don't know what the perception of the public was.

Senator PACKWOOD. It is an unusual name for excise tax—the windfall profits tax.

Mr. KURTZ. I suppose that is right.

Senator LONG. Might I just ask a question? The price of oil is determined by the world market price, and the windfall profits tax means that whatever the American producer is reduced by the amount of the tax. Now, how in the name of commonsense can you say that that is a tax on the consumer? It comes right out of the hide of the producer and nobody else.

Mr. KURTZ. May I excuse myself from this debate, Senator Long? [Laughter.]

Senator LONG. All I am saying is that you people down at the Treasury explained it as being a 100-percent tax on the producer, and that is all I see it as being.

Mr. KURTZ. Mr. Sunley should more appropriately answer that question [Laughter.]

Senator PACKWOOD. I would like to hear Emil's answer.

In answer to this, in taking Russell Long's theory then, any excise tax is a tax on the producer if they have no way of passing along the cost.

Mr. SUNLEY. That is true. The question is whether the oil producer could pass on the windfall profits tax.

Senator PACKWOOD. Or whether any producer can pass on any excise tax.

Mr. SUNLEY. Yes, but take the windfall profits tax. When Congress enacted that tax in 1980, oil prices had already been decontrolled. So, the domestic price of oil had risen to the world market price. If now you impose an excise tax on the production of domestic oil but not foreign oil, it is very hard to see how domestic producers can raise the price of domestic oil to pass on that tax where, in effect, all oil has to sell at the same price at the refinery gate. Instead producers could substitute foreign oil for domestic. I would agree with Chairman Long that the tax was not a profits tax—it was an excise tax. While most excise taxes are passed on; this one was not.

Senator PACKWOOD. Had we accompanied it then with an oil import fee, it would have been a consumption tax.

Mr. KURTZ. If you had an oil import fee equal to the windfall profits tax—yes, then you would be able to pass the windfall profits tax on.

Senator PACKWOOD. Now, Mr. Kurtz, let me ask you another question. On page 2 of your statement, you are talking about tax expenditures, and you say: These special provisions are called tax expenditures because they are carried out through tax relief programs which more traditionally and more properly should be considered spending programs. You are saying that those things that we want to encourage—assuming that it works to encourage them—we are going to have witnesses later on that say it does—but home ownership, charitable contributions—those ought to be more appropriately supported by direct Government expenditures, assuming they are constitutional in the case of some charities, rather than tax incentives.

Mr. KURTZ. I am suggesting that the items have the same effect as expenditure programs. Whether it is more convenient to carry one out by expenditure through the tax system is a matter of judgment that can be made as to each one.

Senator PACKWOOD. But you say: And should more properly be considered spending programs.

Mr. KURTZ. For the most part, yes.

Senator PACKWOOD. Is that your preference?

Mr. KURTZ. For the most part. Not as to every single item. No.

Senator PACKWOOD. I assume that the items that you wouldn't prefer either have no political constituency to change or items that for whatever reason you personally prefer to use the Tax Code.

Mr. KURTZ. Most tax expenditures, it seems to me, have little justification at all today.

Senator PACKWOOD. All right. You say here, on page 3: Tax expenditures cost the same as comparable direct programs

Now, let's take the mortgage interest credit on housing, as it works today. Do you think you could accomplish roughly the same thing in housing for roughly the same cost as the tax expenditure by taxing the money, bringing it here, passing it out—let's take the Department of Housing and Urban Development as the administrative agency. You want to buy or build a house. You go to the local HUD office. You fill out a housing grant form of some kind. You turn it in. It is reviewed. It is rejected. It is accepted. Or what not. But you could accomplish the same thing at the same cost on that kind of a program as the tax incentive.

Mr. KURTZ. But Senator Packwood, the program you are suggesting would be different from the tax program. And I think your suggestion is that it would cost much more administratively. The answer to that is yes. It would cost much more administratively if there were reviews of an application. The tax system doesn't review applications. It simply says, "tell us what you spent and take a deduction." If we had a mortgage interest subsidy program like the tax program it would simply say "if you pay interest, send us a note that you did and we will send you a check." That is the way the tax system works.

Senator PACKWOOD. And what you are saying then is if you are going to use the direct Government program, that is all it is. I bought a house. My income is $50,000. I am in the such-and-such tax bracket. Here is a form that says you owe me $10,000, and without even checking, as you do any kind of spot checks on the IRS, you sent out $10,000.

Mr. KURTZ. I am not suggesting that you take tax expenditures and make them direct expenditures. The only point that I was making was that in looking as to what provisions of the Internal Revenue Code are necessary to the appropriate administration of a tax system—in sense of necessary to determine one's ability to pay tax—there is one set of provisions. At the same time in the Internal Revenue Code you have another set of provisions which are not necessary to determine what a person's tax paying capacity is. They are there for a different reason and serve a different purpose.

Senator PACKWOOD. Let me ask you a very specific question which later panelists are going to make reference to. Do you think if we eliminated charitable contributions as a deduction, it would have any depressing effect on charitable contributions?

Mr. KURTZ. Yes.

Senator PACKWOOD. Should we do it?

Mr. KURTZ. No, I think not. But let me say that if you lower rates at all, it will have a depressing effect on charitable contributions, or if you raise rates it will encourage them. But I wouldn't recommend raising rates either. It seems to me that some uneasy compromise—

Senator PACKWOOD. That is an expenditure you would keep in the Tax Code—the deduction for charitable contributions?

Mr. KURTZ. To some extent. If I were designing the system from scratch—if you are asking for a personal judgment—and a lot of these things in the end, of course, are personal judgments—I would allow some encouragement for charitable giving, but I would tend to make the encouragement relatively equal for all taxpayers rather than giving greater encouragement for higher income people. I would prefer it to be along the lines provided in the Bradley-Gephardt bill, for example.

Senator **Packwood**. Thank you.

The **Chairman**. Is there anyone on the panel who would recommend increasing personal income tax rates? [Laughter.]

[No response.]

The The President is pretty safe there. OK.

Senator **Roth**. Thank you, Mr. Chairman. Gentlemen, I would like to go back to the question of policy on savings, and ask each of the panelists whether or not how we treat savings in the Tax Code has any impact on the individual saver. Would you agree that there is no significant evidence that it plays a role in promoting savings or not, Mr. Walker?

Mr. **Walker**. No, sir; I would not. I think it has a very significant effect. To say there is no difference whether we go for an income tax or a consumption tax. This overlooks the fact that, with an income tax, we automatically tax savings twice. We tax the saving when income is earned; we tax the income on the savings—invested wherever it is—when it comes along later. Also, Senator Roth, I think you made the point quite appropriately that at some level of interest rates, you get a positive response in the elasticity—as the economists would say—of the savings function, that is, there is some level of interest return that will induce more saving. I think one problem here is that so much of the analysis of the impact of interest rates on saving is that analysis of data covers the 1940's, 1950's, 1960's, and even the 1970's. The 1980's are a new ball game, as you pointed out in your testimony. When we have a situation in which an individual can not only get his investment tax free under an IRA, but he can put that into an investment which doubles in value within a generation or less, then you have an entirely different situation. People will respond positively under those circumstances. But, these changes are very recent, and historical analysis is not much help there.

Senator **Roth**. Mr. Kurtz?

Mr. **Kurtz**. I think the tax on investment income has little to do with aggregate savings, as I understand it. Obviously the tax treatment of one kind of savings over another will shift savings around substantially. And just as obviously, the aggregate tax burden—the money taken out of the economy by the Government—will have an effect on savings, but overall I think, given any particular tax rate, whether favorable to savings or not would not have a very substantial effect. Take to IRA's: I think the evidence is that with the greatly expanded IRA's, while IRA's went up enormously, aggregate savings did not. I mean, people took money out of savings accounts to put it in an IRA for that deduction.

Senator **Roth**. I guess the thing that bothers me as a noneconomist is why would tax policy affect contributions to charity, for example, and not impact upon savings? Why in the one case will an individual react and not in the other?

Mr. **Kurtz**. Maybe we should ask psychologists rather than economists, but there is question of how much after-tax money one wants to put out. If you talk about aggregate savings, the question is whether you actually shift between consumption and savings as a function of the rate of return. That is, whether one decides because interest rates go from 12 to 13 percent that he won't buy the new coat but will save, and if it goes down to 11 percent, he will spend more for a meal in a restaurant. It seems to me, by and large people, consume at a certain level because that is the level at which they want to, and they save the excess. Now, sure, they will put it here or there depending on relative rates of return.

Senator ROTH. The problem I have with what you are saying is sort of a black or white situation.

Mr. KURTZ. No, it is a question of how much.

Senator ROTH. If I might make this comment. Obviously every family is going to have to spend a certain minimum amount for the necessities of life. But there does come an area where you have some choice, or many people—not the very poor—but the middle class and more affluent have some choice. So, it would seem to me that I find it very difficult to follow the reasoning that in certain cases what you do with taxes will impact, such as charity. Would you say, for example, that borrowing has been a problem somewhat as a tax loophole? That because you can deduct interest, that there are those who have taken advantage of that?

Mr. KURTZ. Yes. In those so-called tax arbitrage situations where you can deduct the interest on money borrowe to make an investment—the income from which is not taxed. or is taxed at a lower rate. And obviously, there is a tax arbitrage that one can play.

Senator ROTH. Mr. Christian?

Mr. CHRISTIAN. I think, Senator Roth, that the Federal income tax is primarily a regulatory device, through the interaction of very high nominal rates with all of the various different deductions and exclusions from the base. With all due respect to my friend, Mr. Kurtz, I find it very difficult to think that our tax system which is so powerful in all other respects does not substantially influence the choice between consuming and saving. The influence of the system is largely a function of how high the tax rates are.

Senator ROTH. My time is up, I think.

The CHAIRMAN. You have all had very responsible jobs in Government. Have your views on taxation changed at all since you left the public sector and returned to the private sector? I mean, I am serious about it—whether or not you view it a little differently on the outside than you did on the inside.

Mr. CHRISTIAN. I will try to answer that, Mr. Chairman. In my case, it is perhaps a movement toward a greater amount of practicality and reality, in terms of what can and cannot be done in this country. The debate about fundamental tax reform in 1985 has thus far has been centered around things that are analytically illuminating. They are theoretically interesting. They provide good sources of ideas. But ultimately, we are simply going to have to get down to the practical proposition that we cannot raise rates because rates are already too high. If we are going to raise revenue, we simply either have to expand the income tax base or we have to add to the income tax base some other base such as consumption.

The CHAIRMAN. That makes the point. We can't do anything unless we have the votes up here, and I have discovered sometimes that a lot of great ideas never have many votes. You have all been before this committee, trying to get us on record for something.

Mr. WALKER. I was going to say that my views haven't changed all that much. I recall that the last major tax legislation I managed in Treasury in 1971 was to restore the investment tax credit and set up the ADR accelerated depreciation system. These are basically the same directions I have been working since that time.

The CHAIRMAN. I won't——

Senator LONG. I have one question I would like to ask all four. How many of you here believe that this Tax Code, in addition to raising revenue for the Government, should seek to achieve social and economic objectives in the way that it raises the revenue? Mr. Walker, I know your answer obviously because you believe that the tax system ought to have provisions in there to achieve capital formation, to encourage savings and achieve capital formation. I would just like to know what all four of you think about it. Do you want to elaborate on that, Mr. Walker? Do you think it should have some other objectives, or just stop right there?

Mr. WALKER. No, I would make this very brief comment. If we were starting with a clean sheet of paper and could set up a neutral tax system, such as the value-added tax, I would favor that. We don't have that. We have a sheet of paper that is chock full, and under those circumstances, as Senator Packwood and others make very clear, our tax system encourages some very important social goals with respect to church, to charity, to retirement, to medical care, and so on. I think as long as we have that, we should nurture it, not undercut it.

Senator LONG. Mr. Kurtz?

Mr. KURTZ. By and large, we ought to try and move toward as neutral a system as possible.

Senator LONG. Mr. Christian?

Mr. CHRISTIAN. I think we ought to make the attempt to move toward a broader based lower rate tax, perhaps supplemented by some consumption base. I do not think that we can continue down the road that we are on now, both using and overusing the Federal income tax system as a device for social and economic engineering. A certain amount of that is good, but we have wound that spring just about as tight as we can wind it.

Senator LONG. Mr. Sunley?

Mr. SUNLEY. I joined the Treasury Department in 1968. I served twice with the Treasury Department and I went through some nine different Secretaries of the Treasury. I sometimes think that we would be better off if we went back to where the Internal Revenue Code was when I joined the Treasury in 1968. If you took the 1968 laws, before the Tax Reform Act of 1969 you could have the committee staff work up marginal tax rates that would raise roughly the same revenue as existing law on that broader 1968 tax base. I think a lot of Americans would prefer the 1968 law, and current law with all the changes that we have made since. You just need to go through the tax form to see how many different tax credits and how many special rules have been added since 1968. As a result, we haven't been able to keep marginal rates down as much as we could have.

Senator LONG. It seems to me that it is as simple as a surgeon getting ready to operate, whether you use a scalpel or whether you use a pair of scissors. When you look at an objective, you ought to think in terms of which way can you solve the problem most efficiently. That is all there is to it as far as this Senator is concerned. Can you solve it more efficiently by using the tax law, or can you solve it more efficiently by using a similar law, or can you solve it more efficiently by using an appropriation. The one that does it the most efficiently is the one you ought to use. Now, we have a whole bunch of expenditures that maybe we ought to reexamine. Maybe some of the tax expenditures and some of the other kinds of expenditures. To me, it is just a question of the way you can do it most efficiently.

As far as complexity is concerned, I know that the members on this committee, and there are at least two or three of you on this panel right here, who could show us very easily how you could amend the law so that about 90 percent of people wouldn't have to itemize. Right now about 35 percent itemize, but for about 65 percent it is not complicated the way it is now. If it is only complicated for one-third, you could fix it so that 70 percent of those who now itemize wouldn't find it complicated. They wouldn't have to itemize. Do you agree with that, gentlemen?

Mr. WALKER. I think the simplicity aspect is very much overstated. It is simple now for most people.

Senator LONG. Mr. Kurtz?

Mr. KURTZ. There is another aspect to that. Certainly, you are right. For 65 percent of the people filling out their form, life is fairly simple. But I think the problem is that that 65 percent think they are being cheated by the other 35 percent who have a range of deductions and shelters. And that is a problem, that can't be overstated. We have very serious compliance problems in this country among those who file simple returns, as well as among those who file complex returns. But they don't understand the system. When people don't understand the system, they think they are being abused by it. And I think that is a widespread belief.

Mr. WALKER. But that is a different issue.

Senator LONG. You are talking about a person having a deduction or abusing something—something that is subject to abuse—and it ought to be corrected if we can. I am just talking about the matter of simplicity. Do you two agree that we could simplify this for 90 percent of the people?

Mr. WALKER. You could certainly do that.

Senator LONG. Mr. Sunley?

Mr. SUNLEY. From the 1969 act through at least the 1978 act there was a movement in Congress to try to simplify the tax for the bulk of all the taxpayers by getting them out of an itemizing situation and into one where they used the standard deduction. That succeeded. But then, of course, there was the problem that the charities felt this was cutting into charitable contributions, and it may well have been. We have not increased the zero bracket amount or raised the personal exemption since 1978. The personal exemption would have to be $1,600 today to offset the impact of inflation since 1978. But during the 1970's it was the increases in the zero bracket amount, getting people off itemized deductions, that was a major simplification for the average taxpayer

Senator LONG. If I might just comment and make one more statement, Mr. Chairman. I don't think it should be difficult to fix it so 90 percent of the people could pay their taxes in a very simple fashion without itemizing.

Mr. **Sunley**. When the standard deduction was first introduced, over 80 percent of the people used it.

Senator **Long**. Now, about the question of fairness. It just seems to me that if we are going to have an option that a person can itemize and claim all the deductions then we ought to take a very close, careful look at the areas of abuse. I recall when I came here the unlimited charitable deduction was available. In time, we started the first tax reform act—I guess that was 1969, wasn't it, Mr. Sunley?

Mr. **Sunley**. Yes, sir.

Senator **Long**. At that time, we had studies indicating that all sorts of millionaires were paying no income tax, and most of them were getting just unlimited charitable deductions. When we got into the situation, we found that there was a nun up in Philadelphia who wanted to give her income all to charity. She had taken a vow of poverty. So, the next thing you know, by the time we corrected the law so she didn't pay a tax—so she could give all of what she got to charity—the next thing you know we saw that about 30 percent of millionaires in America were paying no income tax. They were all claiming to be doing the same thing as the Philadelphia nun. [Laughter.]

And half of them didn't have a drop of human kindness in them. [Laughter.]

So, we had to go after that problem, and we got it pretty well straightened out. But we ought to go after problems like that more quickly and more effectively.

The **Chairman**. Senator Grassley, did you have a question?

Senator **Grassley**. I think that Senator Long has covered pretty much what I wanted to because of my interest in compliance and maybe it is sort of nebulous, but keeping public confidence in the tax system must be high in order to keep voluntary compliance going. So, I guess maybe as a followup, I would just simply ask of these various forms, of a simplified tax or alternative tax, which would you consider the one that would enhance public credibility in the system so that we would keep compliance high?

The **Chairman**. If any.

Senator **Grassley**. If any, yes.

Mr. **Walker**. Which alternative?

Senator **Grassley**. We have four or five that Senator Dole suggested that we——

The **Chairman**. I didn't suggest any of them. [Laughter.]

There are four or five we have alluded to.

Senator **Grassley**. Yes. [Laughter.]

The consumption tax, national sales tax, income tax——

Mr. Walker. I think probably the DeConcini flat tax, which is the Hall-Rabushka proposal, would probably do more simplifying than any of the others. Two other proposals keep, in some degree, various deductions and credits.

Senator **Grassley**. Understand that I am not saying which would be the most simplified. Which one would go the furthest to increase public confidence in our tax system, so that we have more compliance?

Mr. **Walker**. No. I have seen recently that what the public says in polls conducted by the Advisory Council of Intergovernmental

Relations [ACIR]—a blue ribbon group of mayors, Governors, and so on. Over the years the polls have indicated that if taxes must go up, people would prefer that they go up in the form of a sales tax, rather than an income tax. The poll last summer—a year ago—showed that spread was 52 to 24 percent. The poll referred to an ordinary sales tax, the simplist type. You just pay it when you buy something from a store. But any time you have an income tax, like we have now, adjusted in various ways, I think you are going to have trouble with the happiness of the American people. I think the income tax has come to the stage where it is a very unpopular thing in this country. It is unpopular now, it seems, partly because of the high marginal rates that upper middle income taxpayers are hit with—35, 40, 45 percent. The Tax Code in the 1930's was set up to soak the rich, not the middle income people.

Our research indicates that there is even a more important factor today—that middle class people on salaries who have all of their taxes deducted, are becoming increasingly unhappy if not furious with the tax evaders of the underground economy—who are people evading upward of $100 billion a year in taxes. We know that they are there. We all deal with them. And middle class taxpayers are unhappy with the tax avoiders of the higher income groups, people who they believe don't pay any taxes because of tax shelters. And so, the middle class has said, "we just don't like the income tax." That is why I think you have got to——

The CHAIRMAN. Where is that middle class? What range is that?

Mr. WALKER. I take a realistic definition, not a statistician's definition. It is family income of about $15,000 to $60,000, or $65,000 or $75,000 a year. And incidentally that is where the tax money has got to come from. When Willy Sutton was asked. "Why do you rob banks?"—he said. "For crying out loud, that's where the money is." And that is where the money is as far as tax collections are concerned.

The CHAIRMAN. Senator Chafee?

Senator CHAFEE. Mr. Kurtz?

Mr. KURTZ. I was going to say I agree with most of what Charlie said about the present system, but I think your question is where would I like to go. Which system do I think would be perceived as the fairest? And I think of the ones that are on the table Senator Bradley's would be widely viewed as a fair tax.

Senator GRASSLEY. Mr. Christian?

Mr. CHRISTIAN. I have avoided, Senator Grassley, getting too much familiar with the details of any of them because I don't think any of the proposals are quite where they want to be yet. I am concerned that all of the flat tax proposals inevitably will lead to larger and larger exemption levels that take more and more people off the tax rolls. It is hard for me to believe that Congress is actually going to impose a flat 20 percent tax rate on people in so-called lower income levels. I would prefer some progressivity in tax rates. On the other hand, some of the progressive rate proposals—such as Senator Bradley's—perhaps make an error by compressing rates into fewer and fewer brackets. The question of progressivity is not necessarily so much just what the rate is, in the progression from the highest rate to the lowest rate, but is also a question of when and at what amount of income you hit that rate. I would think that some thinking should be done in the area of bracket widening with respect to some of these broader based proposals, rather than bracket compression.

Mr. **Sunley**. Senator Grassley, I believe your question related to the various reform proposals—which would I favor on compliance grounds? I suppose you would have to look at transactions-based consumption tax, such as a value-added or retail sales tax. I assume that these taxes would not replace our existing income taxes. There are clearly administrative costs to introducing a whole new tax into the federal system, but a transactions-based consumption tax probably could be administered with a high degree of compliance. The Treasury Department, in the studies that your committee and the Congress has instructed them to undertake, is also looking at other types of consumption taxes, such as a progressive consumption tax which is based on the income of the individual less his savings. But I think these kinds of consumption taxes have a number of problems in the compliance area which I don't think the Treasury is going to be able to solve. One of the major problems is the movement of assets overseas. Since these proposals are all variations of a super-IRA account, as long as you have assets sitting overseas when the tax goes into effect, you can make contributions to your super-IRA account out of your overseas funds. There are many ways that the progressive consumption tax probably can be manipulated, at least as many ways as the progressive income tax. So, between the broad-based consumption tax and the broad-based income tax, both with progressive rates, there probably isn't a reason to prefer one over the other on compliance grounds.

The **Chairman**. Let me suggest that we hoped to be able to complete these hearings this morning, or between now and sometime without a break. So, if I could ask members if they would just limit their questions as much as they can. We have a good panel. We don't want you to escape without good questions, but I will yield now to Senator Bradley, and then to Senator Danforth.

Senator **Bradley**. Thank you, Mr. Chairman. Let me ask Mr. Walker a few questions. First, why in your view wouldn't the greatest tax incentive for savings and investment be the lowest possible tax on profit?

Mr. **Walker**. That would be one incentive. I don't say it would be the greatest because business savings—are you talking about profits of business?

Senator **Bradley**. I am talking about profit.

Mr. **Walker**. If you are talking about business profits. But that does not take up the individual saving, which is a very big part of the private sector.

Senator **Bradley**. Surely, returns to private savings are a function of how profitable the investment is. After all, savings have to be invested to earn any return. My point is that we have a Tax Code that imposes low tax rates on some investments and higher rates on others. This biases the choice in favor of investments that are tax-profited. Our argument is the lowest possible tax rate on all profit is the greatest stimulus to savings and investment. And I wondered if you would agree with that, or if you would prefer to have some industries paying an effective tax rate of 40 percent, other industries paying an effective tax rate of 10 percent. Which do you think is the most efficient allocation of capital and in the interest of the broad-based American public?

Mr. **Walker**. Two things there. First, you, have to ask why are they paying the lower tax rate. If they are paying the lower tax rate because of the operation of the investment tax credit and accelerated depreciation, then the tax system itself—despite the fact that there are differential rates—is giving you that higher rate of capital formation. So, I would have to disagree, I think, with your fundamental point. I think you have got to get behind the question and ask why there are differential rates.

Second, when you think of the efficient allocation of capital, recall that Congress, in moving toward capital formation measures in 1978 and 1981, was in effect saying we are not getting enough capital formation. Congress said: Let's move our tax system in a direction so we will get enought capital formation.

Senator **Bradley**. Rather than a significant increase in capital formation, what ACRS and the ITC have done in direct resources into short-lived equipment at the expense of other more productive investment, especially industrial structure, my other question relates to whether you think a tax system with already built-in incentives for companies to do certain things is better for long-term growth than one with the lowest possible rate? I ask the question first on the basis of profits. What about on the new company that has done the research, that makes a new invention, that wants to market it. That company is competing against industries that are heavily subsidized by the tax system. Is your answer to give the new industries that are really the growth industries in the next decade additional subsidies, or would you like to see all industries compete on a level playing field?

Mr. **Walker**. I would like to see the tax system recognize new industries and new activities. One of the greatest things that happened to new industries and new initiatives was the reduction of the capital gains tax in 1978. This can be viewed in some respects as the most successful tax cut in history. Revenues rose, the stock market went up, venture capital gushed out all over the country. So, in the establishment of those new high-risk businesses, which require venture capital, just cutting back on the capital gains tax made that possible.

Senator **Bradley**. Then you would recommend no further tax subsidies?

Mr. **Walker**. I might recommend some very strongly. I was very disappointed to see that the House of Representatives did not accept the extension of the R&D credit which was voted in the Senate. This is very important because the modification of ACRS hurt some of those industries.

Senator **Bradley**. So, your view is to give to emerging industries their own tax benefits and ultimately pay for that with higher tax rates on everybody else, rather than lowering the tax rate on everybody and having them compete for the available capital? Did I state that correctly or not?

Mr. **Walker**. Senator, I think that we are dancing around something here that is much more fundamental, and that is a question whether we should have taxes on business or corporations at all. Those taxes are either passed forward to consumers or back to the people who form the company, the stockholders, or to labor, if workers have to take a big wage cut because of the tax impact. When you understand the fundamental, that corporations don't pay taxes people do, and we don't even know what the distribution is, then to try to fine-tune a system which doesn't make sense in the first place doesn't quite make sense in itself. Suppose you get effective tax rates among industries all equal, some way or other get all industries and all corporations paying exactly the same rate, that doesn't tell you you have equity. We can't judge equity at all until we know how corporate taxes are allocated among customers, workers, and owners. And we know little about that. I don't think anybody in Congress has really gotten behind the system enough to ask these fundamental questions of who ultimately pays that tax. That is what we have to determine if we are going to judge equity to any final and fundamental sense.

Senator **Bradley**. May I just ask one question quickly to Mr. Kurtz. If we took some bold steps and knocked the foundations out of various tax shelters, you would have a lot of IRS personnel that wouldn't be pursuing exotic tax shelters. What would you have them do, and how would you ensure the compliance increase that Senator Grassley would like?

Mr. **Kurtz**. As you probably know, the IRS audit coverage has been going down dramatically over the past 6, 7, 8 years. The Service has gone from auditing 2.5 percent of returns in 1978 to now auditing 1.3 percent or 1.2 percent of returns. So, there is plenty of work to do.

The **Chairman**. Senator Danforth?

Senator **Danforth**. Charlie, I think, is the only witness who has addressed this question this morning, but as long as we are talking about tax reform, do you or would you recommend that we do something about the corporate income tax and, if so, what? Charlie, do you have anything to add to your answer? I take it your answer is to repeal it.

Mr. **Walker**. Yes, but I know that is not possible. I would, first, protect what was done so substantively and to such good effect in 1981. The knives are out, believe me, to cut back on ACRS. The outgoing Assistant Secretary of the Treasury said in a recent speech that it was probably too liberal. Business Week has written an editorial to that effect. Press reports from the Hill that are in the press indicate that some people want to throw out what we have and put something new in its place—and I say again, it is working well, and if it ain't broke, don't fix it.

Second, I would suggest that by a combination of putting in a consumption tax, yes, some sort of national sales tax at a relatively good rate, you could raise some money, not only to reduce the deficit over a period of years——

Senator **Danforth**. I was just asking about the corporate end——

Mr. **Walker**. That is my point. The corporate tax, I think, under that system could be cut back as is proposed in the Bradley-Gephardt bill and some other bills, to about 30 percent. If you cut back the top individual rate to 30 percent also, then you have a better balance in the tax system.

Senator **Danforth**. Mr. Kurtz?

Mr. **Kurtz**. The ideal solution, if you believe in an income tax, would be to eliminate the corporate tax and tax the income, properly computed, directly to the shareholders.

Senator **Danforth**. Would you recommend that?

Mr. **Kurtz**. Distributed or undistributed.

Senator **Danforth**. Would you recommend that?

Mr. **Kurtz**. Let me say we worked on that when I was in Treasury in the 1960's and there were very, very difficult problems. Maybe smarter people have come along and figured out how to do it efficiently. But if it could be done, yes.

Senator **Danforth**. Mr. Christian?

Mr. **Christian**. I think we will always have a corporate income tax, Senator Danforth. But I do think we ought basically to leave it alone. We ought to recognize that as long as we do not return to a system of taxing capital, or at least taxing it inordinately, and as long as we keep the depreciation system we enacted in 1981 basically intact, the corporate income tax is not going to be a major revenue producer. That will increasingly be the case in the future as capital becomes a larger and larger element to more and more businesses.

Senator **Danforth**. Mr. Sunley?

Mr. **Sunley**. Senator Danforth, one of the things I find somewhat confusing in the debate to go to a broad based, low rate tax, relates exactly to what Charlie Walker was saying about new investment. We have a system now with very generous tax benefits associated with new investment where the effective tax rate on that new investment is close to zero. Yet, we still do raise some corporate income tax, primarily from the income of old investment. If you were going to all of a sudden switch midstream here, cut back on the accelerated depreciation and raise marginal rates, you would end up cutting the tax on existing investment, the old investment, and raising the tax rate on the income from new investment, compared to current law. As you well know, I suggested to the committee in 1980 that some of the depreciation schemes being considered at that time were too generous, and I thought there were going to be a lot of distortions. But now the problem is that we have that system in place, and we have a very low tax rate on new investment. Do you really want to raise that tax rate on new investment as part of an overall tax reform? This is an example of a transitional problem—how do you get from here to there?—that is going to plague this committee as it considers these proposals for broad based taxes.

Senator **Chafee**. I would like to ask the members of the panel a quick question. If we went to eliminating the deductions, credits, exemptions, and so forth, and then realized that we have got to backtrack a little bit—there has been a lot of discussion here at this table of home mortgage interests and deductions to charitable and so forth—what form, if you had a choice for such deductions, which ones do you think should be included in there? I will try Mr. Kurtz first.

Mr. **Kurtz**. One of the criteria ought to be whether the deduction has led people to make long-term commitments on the basis of the continued availability of deductions. And I would put in that category the homeowners deductions. I mean, people have made commitments on mortgage interest and the size of the house, depending on deductions.

Senator CHAFEE. You mean that we ought to continue that because people have made commitments?

Mr. KURTZ. To some extent.

Senator CHAFEE. Not necessarily that it is good.

Mr. KURTZ. No, it is not good, but people have made commitments. I would prefer to see it retained for some limited period of time or phased out over some long time, but I think that is one that very well could be retained for some considerable length of time.

Senator CHAFEE. How about the charitable?

Mr. KURTZ. Yes, I would retain it to some extent, that is, at least up to a certain percentage. I would try either to turn it into a credit or level the deduction, so that it has the same value to everyone.

Senator CHAFEE. Any others that you would keep?

Mr. KURTZ. Perhaps catastrophic medical, over some significant period.

Senator CHAFEE. How about you, Mr. Christian?

Mr. CHRISTIAN. I have used up my four.

Senator CHAFEE. You only gave three. You have one more

Mr. CHRISTIAN. I think on all of these so-called sacred personal deductions such as charities, homeowners and so forth, there is no reason why the first dollar has to be allowed as an itemized deduction. You could put a floor under each of them, and say, for example, that it is only homeowner interest above a certain amount that is deducted. I would prefer that approach.

Senator CHAFEE. Mr. Sunley?

Mr. SUNLEY. Essentially, I would keep the four big itemized deductions or modifying them. And the four big itemized deductions are your medical deductions, your charitable deductions, your interest deductions, and medical.

Senator CHAFEE. No, you gave medical first.

Mr. SUNLEY. Mortgage interest is the fourth then.

Senator CHAFEE. Medical, charitable, mortgage interest. What was the other one?

Mr. SUNLEY. Oh, State and local taxes. I'm sorry.

I think the one on which you could make most progress is the State and local tax deduction. The reason I say that is that if you are concerned about subsidizing Government activities, you always have the question of whether you want to subsidize State and local government spending by permitting people to itemize their State and local taxes on their Federal tax return. Now, you may want to retain the real property tax, which is primarily a tax at the local level, and is very much tied into the subsidy of housing. But one could look very closely at the itemized deductions for income and sales taxes and whether those should be retained. The other three major itemized deductions I think you do retain, and I have always been intrigued with the proposal that Mr. Christian made to place a floor under itemized deductions—only itemized deductions over a certain amount would qualify as a deduction.

Senator **Chafee**. That is a little different from having a ceiling, isn't it? There has been some talk here of having an interest deduction ceiling.

Mr. **Sunley**. On something like mortgage interest.

Senator **Chafee**. Yes.

Mr. **Sunley**. Yes. They were prepared to subsidize housing so far, but for luxury homes you can only deduct the interest on the first $100,000 of mortgage.

Senator **Chafee**. Do you have that, too, as well as your floor?

Mr. **Sunley**. I have looked at that proposal before, and found there is some attraction to it.

Senator **Chafee**. Mr. Walker?

Mr. **Walker**. Senator, I would like very much to pass on that, for this reason. I just looked through the list of tax expenditures published by OMB and there are a few that are very small. It would be easy to say let's eliminate those. But even if I said that, I would be roundly attacked. Here is one for adopting children, or something like that. Unless you are going to face up to the big tax expenditure items—the contributions to pension plans at $51 billion, mortgage interest at $23 billion, or medical plans at $18 billion—you are just not going to get any revenue. If you deal with the cats and dogs, they are less controversial, but the money is on the big ones. I wouldn't fight that.

Senator **Chafee**. Thank you. Thank you, Mr. Chairman.

The **Chairman**. Let me just ask one question. There has been a little talk about VAT recently—in fact, a lot of it. And I don't know. Would you repeal the income tax and replace it with VAT? Is that—Mr. Walker?

Mr. **Walker**. No, sir.

The **Chairman**. It would just be an add-on?

Mr. **Walker**. It would be an add-on and a partial substitution. What I would like to see is some sort of national sales tax, whether VAT or a sales tax at the point of final sale, which would be simpler and easier to put into effect—phased in at a rate high enough so that you could use the revenues, one, for deficit reduction, and two, to cut individual income tax rates and corporate tax rates basically along the line of the Bradley-Gephardt rate structure, or maybe the Kemp-Kasten, or one of the other proposals.

We could end up by, say, 1990 with a three-legged tax system, Mr. Chairman. First, a payroll tax, second, an income tax but with those abominable marginal rates considerably lower, and third, a national consumption tax. I think that would stand us in good stead domestically and in very good stead internationally.

The **Chairman**. Again, I think we have had a good discussion. We are going to be having more of them. I think without any doubt in my mind, we have got a long way to go before we are going to reach a consensus. A national sales tax—I doubt if there is one vote for that on this committee unless you have a proxy. [Laughter.]

And I am not aware of that. But I think just the name frightens most people in politics. If you can rename it and put a different package or wrapping around it.

Mr. **Walker**. Call it the windfall profits tax. [Laughter.]

The CHAIRMAN. Now, that wouldn't appeal to me. I don't know about the others. [Laughter.]

But I do believe we have made some headway this morning. I don't know how you measure that, but I guess 10 to 1—that is one way of measuring it. But we appreciate your help, and we will be looking at this. This is a bipartisan group. I know you have different philosophies on tax policy, and we will be calling you to help us in the future. Before I call the next panel—or while this panel is leaving—we have the chairman of the Joint Economic Committee, Senator Jepsen, who would like to make a very brief statement. Roger, why don't you go down while we are waiting for the next panel and give your statement?

Then, we will have one more panel which will conclude today's hearings, and then we start again at 10 on Thursday morning.

Senator Jepsen, we are very pleased to have you, and we have been reading with some interest some of the work that you have been doing in the Joint Economics Committee. I know you have had a number of hearings looking at different options, and if you can shed any light or at least give us your insight, it would be helpful.

STATEMENT OF HON. ROGER JEPSEN, U.S. SENATOR FROM THE STATE OF IOWA

Senator JEPSEN. My remarks will be very brief, Mr. Chairman. I appreciate the opportunity to comment on the need for continuing tax reform, and I emphasize the words continuing reform because we already have had some meaningful strides in lowering marginal tax rates in the Economic Recovery Tax Act of 1981. The success of those tax rate reductions has stabilized tax revenues as a percentage of gross national product and has provided some powerful economic incentives that I think are reflected in one of the strongest and most sustained periods of economic growth that our country has ever experienced. Yes, I have held a number of hearings on tax reform. Specifically, we have held hearings on the FLAT tax proposals, both with the authors and proponents of it and the opponents of it. I find when we call in additional witnesses, that everyone is in favor of a flat tax as long as their particular tax exemption stays in place. But everyone without exception is for what flat tax connotes, or what it says to people in this country, and it says two things: one, it is simple, and it is fair. I don't know what flat says in the Webster dictionary, but it is simple and it is fair, and we should strive for that. But we do have, Mr. Chairman, our Achilles' heel, in any kind of tax reform which, whatever we do, must be done very carefully. With telephone, airline, and truck deregulation, and many other things we have done, we ought to approach tax reform very carefully. And we have the Achilles' heel that spending by the Federal Government is still way too high and not under control. It has been slowed, but Government spending continues to be an excessive burden that must be brought under control. The need to control spending, however, should not blind us to the need for further tax reform in an effort to further eliminate the disincentives of high marginal tax rates, which will improve economic growth prospects even more. I note that several of the flat tax proposals have the advantage of lowering marginal tax rates, while protecting the economically disadvantaged and the working poor, and these efforts should be applauded, but we must be ever vigilant to avoid the trojan horse of higher tax in the guise of tax reform because I note, with some of these proposals, that characteristically is evident. Finally, Mr. Chairman, the threat of a large tax increase would bring this current economic expansion to a halt. As chairman of the Joint Economic Committee, if I can leave a brief message, in our sincere desire to bring about tax reform, we must be very careful that we do not fix something that isn't broken. This would be tragic. The current recovery is the best since World War II, and it has created over 6 million new jobs. And I don't think that we can jeopardize the progress that we have made by proposing huge new tax increases even if we disguise them as tax reform. Finally, Mr. Chairman, when we talk about this simplicity and the fairness of the proposals, I also think we should keep another very basic principle in mind, and that is that the people do a much better job of spending and handling their own money than the Government does. And that has always been true. So, whatever type of tax reform that we work toward, it should keep that one goal in mind, and that is we do reward those folks who do the work, who earn the money, who pay the bills, and obey the laws and do the things in this country that our basic system of private free enterprise provides and rewards, and that is hard work and risk. And we have got to be careful with tax reform that we don't discourage those two things. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Jepson. We appreciate your views as chairman of the Joint Economic Committee. We appreciate your waiting while we finished the last panel.

We now have another outstanding panel of witnesses. Jack Carlson, executive vice president and chief economist of the National Association of Realtors: John O'Brien, chairman of the executive committee of the Municipal Securities Division of Salomon Bros.; Brian O'Connell, president of the Independent Sector: and William G. Bowen, president of Princeton University for American Council on Education.

And while they are taking their seats, I would like to include in the record a brief study done—an analysis done—by the Joint Tax Committee, a letter to me from David Brockway dated August 6 in which he looks at the revenue and distributional impacts of the Bradley-Gephardt and Kemp-Kasten tax reform bills. He indicates that the most recent tentative estimate of the revenue impact of the Bradley-Gephardt bill is that it would reduce revenues by a modest amount in calender year 1985, less than $10 billion. It would be about neutral in 1986, and raise about $10 billion in 1987, and $20 billion in 1988. The primary reason it does that is that they repeal indexing. They would not change the corporate tax rate relative to what had been raised prior to 1984. In the first year of the revenue yielded by the Kemp-Kasten bill, it would be between $5 and $10 billion less than that of the Bradley-Gephardt. In the future years, the Kemp-Kasten bill would generate a revenue loss that would go over time primarily because it phases in reduction of the capital gains tax, including indexing the base of capital assets for inflation and removing of the limit of deduction of capital losses against ordinary income. The flat rate in the bill eliminates bracket creep, and they also have a peculiar relationship between corporate and individual tax rates. They go on to say that, unlike Bradley-Gephardt, the Kemp-Kasten bill would not be distributionally neutral among income classes. If the latter proposal were applied to 1982, the latest year for which we have individual income tax return data, upper income taxpayers would have experienced a tax cut of about 15 percent and middle income taxpayers would have experienced a tax increase of about 2 to 3 percent. They also indicate some other changes, but on a preliminary basis, I think it is interesting information, and we will make it part of the record.

We are very pleased to hear Dr. Carlson. And again, I would say that all your statements will be made a part of the record. If you can summarize the principal points, then we would be happy to ask some questions.

[Mr. David Brockway's letter follows:]

98TH CONGRESS, 2ND SESSION

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AUG 6 1984

Honorable Robert Dole
United States Senate
Washington, DC 20510

Dear Senator Dole:

This letter is in response to your request for information about the revenue and distributional impact of the Bradley-Gephardt and Kemp-Kasten tax reform bills.

We have been reluctant to publish anything more than very tentative estimates of the impacts of these and similar bills because the data on which such estimates would be based are very crude. As part of its tax reform study, Treasury is planning to upgrade its estimating models, so that much better estimates will be available next year. Furthermore, the estimates we have made do not yet take account of the recently passed tax bill, which will reduce the revenue gain (or increase the revenue loss) from both Bradley-Gephardt and Kemp-Kasten because it contains some of the base broadening measures on which those bills were relying to offset their rate reductions.

Our most recent, tentative estimate of the revenue impact of the Bradley-Gephardt bill is that it would reduce revenues by a modest amount in calendar year 1985 (less than $10 billion, which is well within the range of error of our present estimating methods for such a bill), be about revenue neutral in calendar year 1986, and raise about $10 billion in 1987 and $20 billion in 1988. The primary reason the revenue yield grows is that the Bradley-Gephardt bill repeals indexing. Roughly speaking, the 1984 Act can be expected to reduce each of these numbers by about $10 billion. We have made no attempt to translate these calendar year estimates into fiscal year revenue estimates because the fiscal year impacts would depend on how the wage withholding system is adjusted, a matter left open by the bill.

The Bradley-Gephardt bill would not change corporate tax revenues relative to what would have been raised prior to the 1984 Act. There would be a corporate tax cut, amounting to less than $5 billion per year, relative to the new law. The distribution of the individual income tax burden by income class would remain essentially unchanged by the bill.

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, D.C. 20515

AUG 6

Honorable Robert Dole
Page Two

In the first year (1985), the revenue yielded by the Kemp-Kasten bill would be between $5 and $10 billion less than that of the Bradley-Gephardt bill. In future years the Kemp-Kasten bill would generate a revenue loss that would grow over time. The reasons for this include the following: (1) the bill phases in reductions in the capital gains tax, including indexing the basis of capital assets for inflation and removing of the limit on the deduction of capital losses against ordinary income; (2) the flat rate in the bill eliminates the "bracket creep" that results from economic growth; and (3) the peculiar relationship between the corporate and individual tax rates, a 30-percent top corporate rate and a 25-percent individual rate, would discourage use of the corporate form of business organizations and thereby reduce revenues because the Treasury now collects a double tax on corporate income distributed as dividends to taxable shareholders.

Unlike Bradley-Gephardt, the Kemp-Kasten bill would not be distributionally neutral among income classes. If the latter proposal had applied in 1982, the latest year for which we have individual income tax return data, upper income taxpayers would have experienced a tax cut of about 15 percent and middle income taxpayers would have experienced a tax increase of about 2 to 3 percent.

It should be noted that each of these bills would have far-reaching economic impacts that are not accounted for in our revenue and distributional estimates. Taking account of these impacts could markedly change the results. Because of this possibility and the forthcoming improvements in both data and estimating models, we have not included the above information in the pamphlet prepared in connection with the committee's hearings on August 7 and 9.

We are working on these matters and will be happy to provide further information on these bills as it becomes available.

Sincerely,

David H Brockway

David H. Brockway

STATEMENT OF JACK CARLSON, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF REALTORS, WASHINGTON, DC

Mr. **Carlson**. Inasmuch as tax policy is part of total Government policy, we obviously have multiple objectives. Obviously, we want Government to help with economic growth. We want redistribution of income. We want fairness. We want simplicity, and we want, in the case of taxes, to raise funds for the objectives we think are best served in the spending area. And so, I think whether we have a revenue system that raises money neutral of these objectives is not what we have and we are not likely to have in the future. Unfortunately, during the last short period of time, we have had some problems with some of those objectives. The investment rate, the net domestic investment rate, the savings rate—the domestic savings rate—has actually gone down the last few years. It is less than half of what it was in the previous 30 years during the period of the 1980's, and this, of course, feeds into redistribution of income in terms of the economic pie being larger for people to satisfy their needs, as well as economic growth to make that possible. Consequently, I think whatever we do with taxes, we have got to encourage additional savings and investment, and the rate would indicate that we are moving in the opposite direction.

Inasmuch as the difficulty of changing policy, we tend to move at the margin. I dare say taking the personal income tax system as we have it now with this progressivity and making some improvements to that to bring about reform is probably about the extent of what will happen. And while you are doing that, making sure that you are moving a little bit more toward a consumption tax, thereby giving more deduction and more encouragement to savings and investment, both on the human capital side and on the physical capital side so that we have the growth for the future. I think that is rather important. Also, I do think that we may want to modify something that technically is out of line, and that is the automatic tax cut we have for personal income taxes—that there ought to be some dampening of the large CPI adjusted amounts each year because the CPI doesn't properly measure whether persons purchasing power stays the same. It has technical problems associated with that. So, changing the personal income taxes by CPI minus 1 or minus 2 or some other figure, I think, would be appropriate in terms of providing the revenues to encourage savings and investment, or to provide the revenues that you are going to need to bring the deficit down.

The **Chairman**. Mr. O'Brien.

[Mr. Carlson's prepared written statement follows:]

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
regarding
PROPOSALS TO REFORM THE FEDERAL TAX SYSTEM
to the
SENATE COMMITTEE ON FINANCE
by
DR. JACK CARLSON
August 7, 1984

I am Jack Carlson, Executive Vice President and Chief Economist of the NATIONAL ASSOCIATION OF REALTORS®. On behalf of the more than 600,000 members of the National Association, we greatly appreciate the opportunity of testifying before the Senate Committee on Finance as you consider proposals to reform the federal tax system. We are pleased to respond to this Committee's request for our views on (1) the distributional effect of lowering tax rates while eliminating most tax preferences; (2) the degree of progressivity desired in the tax system; (3) the practicalities of making the transition to a new tax system; and (4) the options for simplifying the tax system for individuals and corporations. We would also like to suggest other relevant criteria for considering changes in taxes.

RECOMMENDATIONS

We believe that tax policy should encourage growth in the American standard of living through efficient use of resources and result in fairness for all people. In addition to the raising of funds for government spending we believe that government spending should not exceed government tax revenue at high employment. In particular, we recommend that changes in tax policy should:

1. Encourage economic growth through the timely expansion of capacity, including growth in savings and investment, in education and training, and better residential, employment, and shopping areas. Unfortunately, the policies adopted by the Congress and the President during the last four years have been anti-savings and anti-investment causing domestic savings to be much lower than the rates prevailing during the last 30 years (see Table 1).

2. Encourage homeownership. Homeownership leads to greater savings for both residential and business investment, greater family stability and neighborhood solidarity, less crime and violence, and higher voting participation making democracy more effective and meaningful. Homeownership reduces the need for growth in government mandated retirement programs such as Social Security. The policies adopted by the Congress and the President during the last four years have reduced the homeownership rate for the first time in 40 years. This trend will likely continue for the foreseeable future in every state in the union (see Figure 1 and Table 5).

3. Limit use of the consumer price index in adjusting tax rates because of its past and current overstatement of increases in the cost of living for the average household. Rather, accept consumer price index minus 1 or minus 2 percentage points to make this correction. This change should also be applied to the application of the consumer price index to spending programs.

4. Be modest and provide for smooth transition so as not to disrupt the economy or drastically change the value of individual assets and after-tax incomes. Tax changes passed by Congress and adopted by the President this year have reduced the value of rental residential properties and commercial and industrial buildings by $135 billion and will cause an increase in rents equivalent to 2 percent of the median income of all renters, about 4 percent of the income of low-income renters.

5. Recognize the benefits that growth and expansion of job opportunities have had on the earned income refundable tax credit (negative income tax) and on the need for other provisions to be expanded to overcome poverty.

6. Reduce the harrassing provisions of current tax policy that limit individual choice and freedom.

THE NEED FOR MORE SAVINGS AND INVESTMENT

Tax reform should alter incentives so that the private sector is encouraged to save and invest more, and more efficiently. The current federal tax system does not encourage enough savings and investment. Net domestic investment as a percent of net national product has declined sharply since 1980. Even with a strong recovery this year, investment remains below the levels of previous decades.

TABLE 1

SAVING AND INVESTMENT AS A SHARE OF GROSS AND NET NATIONAL PRODUCT, SELECTED PERIODS, 1951-1984

	1951-1960	1961-1970	1971-1980	1981	1982	1983	1984e
			As a percent of GNP				
Gross national savings	15.8	15.9	16.1	16.3	13.3	13.2	14.6
Private	16.2	16.3	17.1	17.2	17.1	17.3	17.8
Federal government	-0.2	-0.5	-1.9	-2.1	-4.8	-5.4	-4.7
State and local government	-0.2	0.1	0.9	1.3	1.1	1.3	1.5
Plus: Net foreign capital inflow	-0.3	-0.5	0.0	0.1	0.2	1.1	2.1
Equals: Gross domestic investment	15.6	15.4	16.1	16.4	13.5	14.3	16.7
Nonresidential	10.4	11.1	11.5	12.8	10.5	10.3	12.7
Residential	5.2	4.3	4.6	3.5	3.0	4.0	4.0
			As a percent of NNP				
Net national saving a/	7.6	8.1	6.9	5.8	1.8	2.1	4.1
Private	8.0	8.6	8.0	6.8	6.1	6.6	7.7
Federal government	-0.2	-0.4	-2.1	-2.4	-5.5	-6.1	-5.3
State and local government	-0.2	0.1	1.1	1.4	1.2	1.5	1.7
Plus: Net foreign capital inflow	-0.3	-0.5	0.0	0.1	0.3	1.1	2.2
Equals: Net domestic investment a/	7.3	7.6	6.9	5.9	2.1	3.2	6.3

a/ Net saving and investment equals the gross flow minus capital-consumption allowances (the depreciation of existing capital). Net national product equals gross national product minus capital-consumption allowances.

Source: Actual data from the U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business; 1984 forecast by the NATIONAL ASSOCIATION OF REALTORS® using the Data Resources, Inc. model of the U.S. economy.

Savings and investment are forecast to grow slowly during the next five years under current tax policy. Even this projection may be optimistic because it assumes that the inflow of foreign capital will stay between one and two percentage points of GNP, a figure much higher than the experience prior to 1983.

TABLE 2

SAVING AND INVESTMENT AS A SHARE OF GROSS AND
NET NATIONAL PRODUCT, FORECAST, 1984-1989

	1984	1985	1986	1987	1988	1989
			As a percent of GNP			
Gross national savings	14.6	13.9	13.3	13.4	13.7	14.0
Private	17.8	17.3	16.9	17.1	17.1	16.9
Federal government	-4.7	-4.8	-4.9	-5.1	-4.8	-4.3
State and local government	1.5	1.4	1.3	1.4	1.4	1.4
Plus: Net foreign capital inflow	2.1	1.6	1.3	1.1	1.0	1.0
Equals: Gross domestic investment	16.7	15.5	14.6	14.5	14.7	15.0
Nonresidential	12.7	11.6	10.9	10.6	10.7	10.9
Residential	4.0	3.9	3.7	3.9	4.0	4.1
			As a percent of NNP			
Net national saving a/	4.1	3.5	2.9	3.0	3.4	3.6
Private	7.7	7.3	6.9	7.1	7.1	6.9
Federal government	-5.3	-5.4	-5.5	-5.7	-5.3	-4.9
State and local government	1.7	1.6	1.5	1.6	1.6	1.6
Plus: Net foreign capital inflow	2.2	1.7	1.4	1.1	1.1	1.0
Equals: Net domestic investment a/	6.3	5.2	4.3	4.1	4.5	4.6

a/ Net saving and investment equals the gross flow minus capital-consumption allowances (the depreciation of existing capital). Net national product equals gross national product minus capital-consumption allowances.

Source: NATIONAL ASSOCIATION OF REALTORS®. Forecast based on a simulation of the Data Resources, Inc. model of the U.S. economy.

Recent changes in tax law--notably the Economic Recovery Tax Act of 1981 (ERTA)--encouraged to a modest extent more savings and investment. But overall, the proportion of tax changes that went to saving and investment were smaller than changes over the preceding 20 years. The small pro-investment and pro-savings gains achieved have been more than offset by increases in interest rates due to huge federal budget deficits. This year federal deficits are taking almost 60 percent of net domestic investment, and by the end of the decade, it is estimated that deficits will take nearly 70 percent of savings. Federal deficits are overwhelming the modest but important gains in private savings and investment due to recent tax reform.

TABLE 3

EFFECTS OF POLICY CHANGES SINCE 1981 ON BUDGET DEFICITS
(billions of dollars)

	1982	1983	1984	1985	1986	Average 1987-89
Surplus or deficit under policies a/ in effect January 1, 1981	-109	-148	-110	-85	-63	-5
Surplus or deficit under policies in effect August 1, 1984	-111	-195	-172	-178	-195	-239
Increase in deficit due to tax and spending policy changes made during 1981, 1982, and 1983	2	47	62	93	132	234
Net domestic savings b/	198	239	323	320	310	345
Net domestic savings as a percent of surplus of deficit under policies in effect January 1, 1981	55.1	61.9	34.1	26.6	20.3	1.5
Net domestic savings as a percent of surplus of deficit under policies in effect August 1, 1984	56.1	81.6	53.3	55.6	62.9	67.8

a/ The deficits for policies in effect in 1981 and 1984 are adjusted for revisions in the CBO projections since publication of the baseline projections in February 1984.

b/ Net domestic savings equals personal savings plus business retained earnings plus inventory valuation adjustment (corporations) plus capital consumption adjustment plus state and local government surplus.

Source: Budget projections from the Congressional Budget Office, The Economic and Budget Outlook: An Update, August 1984. Net domestic savings projections from the NATIONAL ASSOCIATION OF REALTORS® based on a simulation of the Data Resources, Inc. model of the U.S. economy.

More recent tax reform has moved away from the modest pro-investment and pro-savings gains achieved in 1981. Congress recently lengthened to 18 years the 15 year depreciation period for structures enacted into law in 1981 under ERTA. This change will reduce the investment in commercial, industrial, and rental residential structures by an average 4.8 percent each year. This is clearly anti-investment and anti-growth. It will result in an annual loss of more than $7 billion of national income and 200,000 jobs.

TABLE 4

ANNUAL DECLINE IN INVESTMENT IN COMMERCIAL, INDUSTRIAL, AND RENTAL RESIDENTIAL STRUCTURES FROM EXTENSION OF COST RECOVERY PERIOD FROM 15 YEARS TO 18 YEARS

	Percent Decline	Dollar Amount (84 dollars)	Square Footage (84 costs)
Commercial structures	4.2	$1.7 billion	28 million
Industrial structures	4.0	$0.3 billion	5 million
Rental residential structures	5.9	$1.6 billion	39 million
TOTAL	4.8	$3.6 billion	72 million

Source: NATIONAL ASSOCIATION OF REALTORS®, based on a simulation of the Data Resources, Inc. model of the U.S. economy.

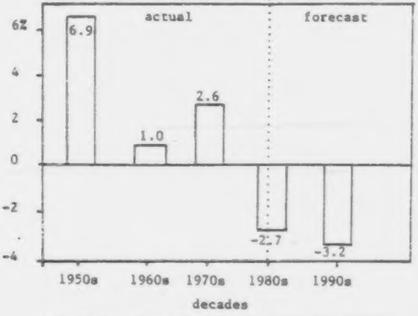
Tax reform should aim at encouraging more savings and investment. One of the biggest incentives for the average American to save turns out to be homeownership. A person stretches to get into a home and agrees to a monthly payment that's a very large portion of income. This encourages a person to save and initially just to invest in his or her home. As income rises and mortgage payments (as a percentage of income) drops, the habit of savings continues and is used beyond the needs of housing.

A 1977 University of Michigan study of household investments (including savings and checking accounts, stocks, bonds and real estate equity) found that homeowners in all income classes save more than renters--on average about 50 percent more--for non-housing purposes, for industry. Homeownership is a great engine of saving.

Clearly, tax reform should provide incentives encouraging homeownership. The Census Bureau has reported an alarming trend--this country's homeownership rate has been on the decline in the last three years, the first drop since the 1930s. In 1980, 65.8 percent of the nation's households owned their home, but that figure stood at only 64.7 percent in 1983. By the year 2000, the homeownership rate could be below 60 percent if the trend of the early 1980s were to continue.

FIGURE 1

CHANGE IN THE HOMEOWNERSHIP RATE
(percentage points by decade)



* Forecast based on 1980-83 trend and other factors considered relevant by the Census Bureau.

Source: U.S. Bureau of the Census.

Based on trends prior to 1980, we would have expected the homeownership rate to be about 67 percent by now. Each one-tenth of a percentage point decline in the homeownership rate represents about 85,000 fewer homeowners nation wide. Since 1980 almost two million households who were expected to be homeowners by now are renting instead. Families in every state have been frustrated.

TABLE 5

REDUCTION IN THE NUMBER OF HOMEOWNERS
FROM 1980 THROUGH 1983, BY STATE

State	Actual Homeowners	Expected Homeowners	Number Lost	State	Actual Homeowners	Expected Homeowners	Number Lost
Alabama	990,000	1,025,000	-35,000	Montana	210,000	218,000	-7,000
Alaska	87,000	90,000	3,000	Nebraska	412,000	427,000	-14,000
Arizona	713,000	738,000	-25,000	Nevada	195,000	203,000	-7,000
Arkansas	610,000	632,000	-21,000	New Hampshire	230,000	238,000	-8,000
California	5,020,000	5,196,000	-176,000	New Jersey	1,624,000	1,681,000	-57,000
Colorado	735,000	761,000	-26,000	New Mexico	327,000	338,000	-11,000
Connecticut	712,000	737,000	-25,000	New York	3,174,000	3,285,000	-111,000
Delaware	155,000	160,000	-5,000	North Carolina	1,481,000	1,533,000	-52,000
Dist. of Col.	96,000	99,000	-3,000	North Dakota	169,000	175,000	-6,000
Florida	2,846,000	2,945,000	-99,000	Ohio	2,716,000	2,811,000	-95,000
Georgia	1,275,000	1,319,000	-45,000	Oklahoma	847,000	876,000	-29,000
Hawaii	167,000	173,000	-6,000	Oregon	680,000	703,000	-24,000
Idaho	252,000	261,000	-9,000	Pennsylvania	3,072,000	3,179,000	-108,000
Illinois	2,624,000	2,715,000	-92,000	Rhode Island	208,000	215,000	-7,000
Indiana	1,442,000	1,492,000	-50,000	South Carolina	768,000	795,000	-27,000
Iowa	784,000	811,000	-27,000	South Dakota	182,000	189,000	-6,000
Kansas	650,000	673,000	-23,000	Tennessee	1,160,000	1,201,000	-41,000
Kentucky	924,000	956,000	-32,000	Texas	3,436,000	3,555,000	-120,000
Louisiana	980,000	1,015,000	-34,000	Utah	331,000	343,000	-12,000
Maine	295,000	306,000	-11,000	Vermont	131,000	136,000	-5,000
Maryland	936,000	969,000	-33,000	Virginia	1,278,000	1,322,000	-45,000
Massachusetts	1,199,000	1,241,000	-42,000	Washington	1,055,000	1,092,000	-37,000
Michigan	2,443,000	2,529,000	-86,000	West Virginia	528,000	547,000	-18,000
Minnesota	1,068,000	1,106,000	-37,000	Wisconsin	1,166,000	1,207,000	-41,000
Mississippi	626,000	648,000	-22,000	Wyoming	123,000	127,000	-4,000
Missouri	1,330,000	1,377,000	-47,000	UNITED STATES	54,463,000	56,369,000	-1,906,000

Source: NATIONAL ASSOCIATION OF REALTORS®, Economics and Research Division. Data from the Bureau of the Census, Census of Housing 1980; and Current Population Reports, Household and Family Characteristics: March 1983, Series P-20, No. 388.

Solving the causes of declining homeownership should be a national priority and a major objective of federal tax reform. Tax reform proposals should pay more attention to the deterrents to homeownership that now exist. If the homeownership rate is prevented from returning to an upward path, the nation is likely to experience less savings (both housing related and non-housing related savings), investment, growth, income and employment, and higher inflation and federal deficits.

TABLE 6

ECONOMIC IMPACT OF A 10 PERCENTAGE POINT DECLINE a/
IN THE HOMEOWNERSHIP RATE BY THE YEAR 2000
(annual result in 1983 dollars)

	Low Estimate		High Estimate	
Savings	- $50 billion	9.7%	- $100 billion	19.4%
Investment in shelter	- $45 billion	9.3	- $100 billion	20.8
Investment in industry	- $55 billion	3.2	- $100 billion	5.9
Employment	- 2,000,000	1.6	- 4,000,000	3.2
Household income	- $1,000	2.2	- $2,000	4.4
Automobile sales	- 900,000	7.5	- 2,000,000	16.7
Federal deficit	$135 billion	--	$300 billion	--
Inflation (%)	0.8	—	1.5	—

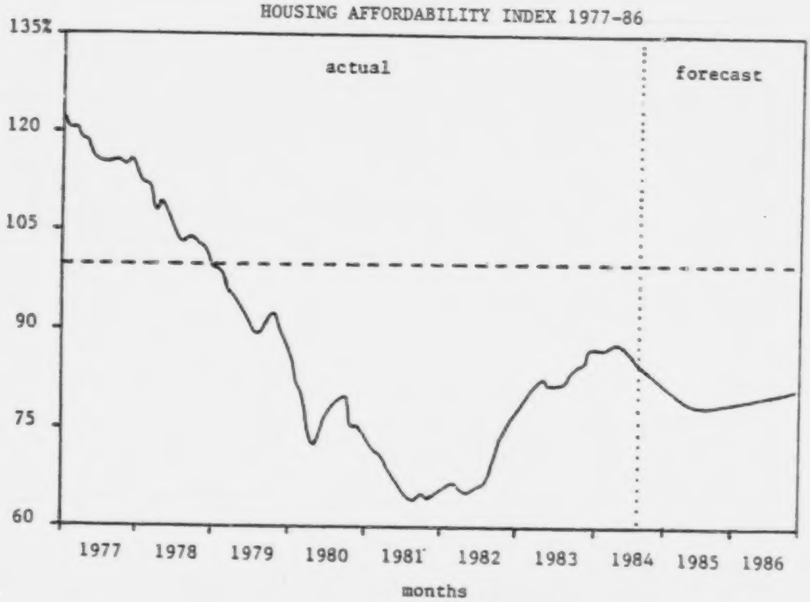
a/ It was assumed that a lower homeownership rate would be associated with slower growth of employment and a decrease in work effort. The slower employment growth lowers income growth which decreases personal savings and consumption. Some research has found that two-earner households are encouraged when people are able to achieve homeownership, and the ability to acquire a home makes people 30 percent more likely to believe if one works hard one will get ahead. Other research shows that if people are unable to achieve homeownership, they no longer feel they can get ahead by working hard, and therefore work effort is reduced.

Source: NATIONAL ASSOCIATION OF REALTORS®, based on a simulation of the Data Resources, Inc. annual model of the U.S. economy. See also Dowell Myers, "The Impact of Rising Homeownership Costs on Family Change", a paper prepared for the Population Association of America, April 1983; and Myers, "Growing Tensions Within the American Dream: The Homeownership Crisis and Social Change", a paper prepared for the Association of Collegiate Schools of Planning, October 1982.

Repeated surveys on what constitutes the "good life" show that homeownership consistently ranks highest among all American households, along with a happy marriage and family. The major cause of declining homeownership is not a preference for renting but a growing affordability crisis. Figure 2 shows the change in the ability of a family earning the median income to qualify for a mortgage on the median- priced existing home. While the index has improved substantially from its low point in 1981 to 85.6 in June (the latest month available), we expect it will remain significantly lower--in the range of 78 to 84--through 1986. (An index of 85.6 means that a family with the median income is 14.4 percent short of the income needed to qualify for a mortgage financing 80 percent of a median priced resale property).

FIGURE 2

HOUSING AFFORDABILITY INDEX 1977-86

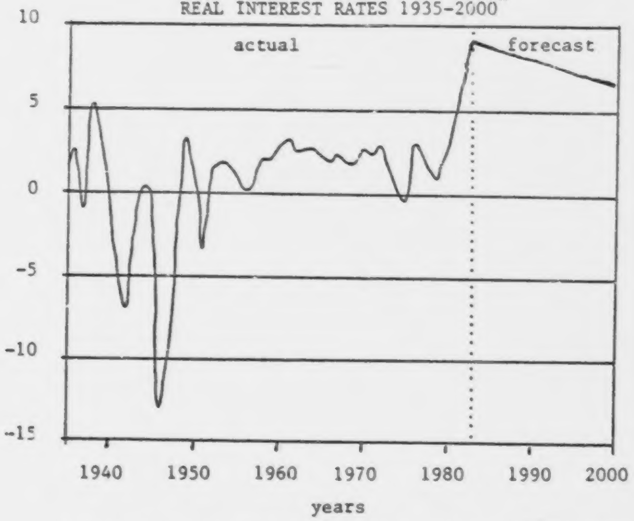


Source: Index developed by the NATIONAL ASSOCIATION OF REALTORS®, Economics and Research Division. Forecast made using the Data Resources, Inc. model of the U.S. economy.

The reason the affordability index has not improved further is because of tax policy and high real interest rates—more than double the average level since the 1940s. High mortgage interest rates are pricing thousands of potential homebuyers out of the housing market causing fewer housing starts and home sales than would be expected based on demographic trends.

FIGURE 3

REAL INTEREST RATES 1935-2000*



* AAA corporate bond rate, adjusted for inflation by the GNP price deflator.

Source: Actual data from the Census Bureau, Historical Statistics: Colonial Times to 1970, and Moody's Investors Service. Forcast from the NATIONAL ASSOCIATION OF REALTORS® using the Data Resources, Inc. model of the U.S. economy.

Real interest rates are high because of the enormous burden of financing the federal deficit. Real interest rates are expected to remain too high to allow the level of investment spending necessary to sustain long-term economic growth. Deficits have increased government borrowing which increases the total demand for loanable funds (current crowding-out), increases fears of future inflation (future crowding-out), and causes a more restrictive monetary policy than otherwise. It turns out that federal deficits are causing over one-half of the current mortgage rate.

TABLE 7

CURRENT CAUSE OF HIGH MORTGAGE INTEREST RATES
(second quarter 1984)

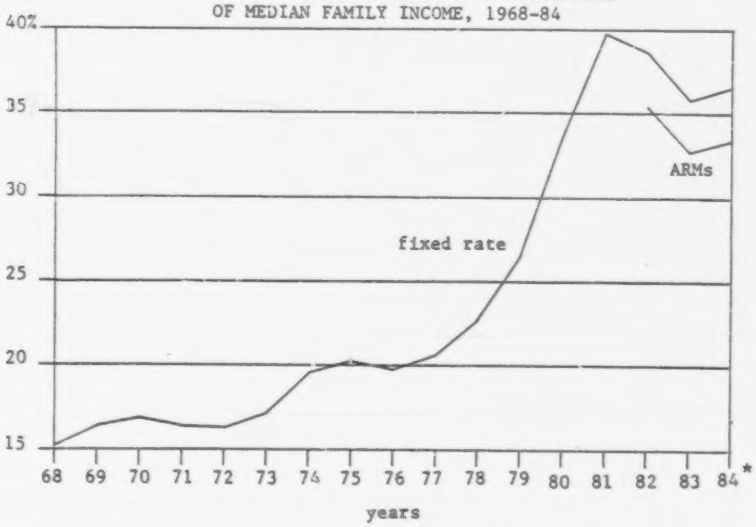
	Percentage Points		Percent of Total	
Fiscal Policy--Deficit		7.8		57
Current Crowding Out	1.1		8	
Inflation Fears--Future Crowding Out	6.7		49	
Monetary Policy Money Growth		6.0		43
ACTUAL INTEREST RATE		13.8		100

Source: Testimony of Jack Carlson before the Joint Economic Committee of the U.S. Congress debating Treasury Secretary Donald Regan's statements on "The Relationship Between Federal Deficits and Interest Rates", October 21, 1983. The estimates are based on an extension and update of several studies and additional empirical analysis by Martin Feldstein and Otto Eckstein, "The Fundamental Determinants of the Interest Rate, The Review of Economics and Statistics, November 1970, pp. 363-375.

Median family income has not been able to keep pace with rising mortgage payments. Since 1980 homebuyers have had to use between 30 and 40 percent of family income just to make their mortgage payments. Even with innovations such as adjustable rate mortgages, families are using more of their income for shelter than ever before.

FIGURE 4

MONTHLY MORTGAGE PAYMENTS AS A PERCENTAGE OF MEDIAN FAMILY INCOME, 1968-84



* January to June.

Source: NATIONAL ASSOCIATION OF REALTORS®.

EVALUATION OF ALTERNATIVE TAX SYSTEMS

Tax reform proposals now under consideration fall into three main groups: (1) simple flat rate tax systems which would broaden the tax base by eliminating all credits, exclusions and deductions in the current law, and use one marginal tax rate for all taxpayers; (2) modified flat rate tax systems which would eliminate most credits, exclusions, and deductions, and use substantially fewer marginal tax rates than current law; and (3) consumption tax systems which would replace income with consumption as the designated tax base.

Virtually all of the sponsors of these tax reform proposals claim their tax systems are revenue neutral, that they raise the same amount of revenue as current law. This claim is extremely difficult to substantiate, even with the use of sophisticated tax models. A tax model can only analyze what would happen in a static sense based on past experience. We would urge the Committee to examine carefully claims of revenue neutrality. Even with such analysis we all must recognize that no tax model can predict in a dynamic sense what changes in economic behavior might occur or what new innovations may arise in response to massive changes in the tax code.

Simple Flat Rate Tax

Under this proposal, individuals are taxed on their income at a single flat rate. The single tax rate is applied to gross income after adjusting for personal exemptions.

The simple flat rate tax proposal provides no incentives for private savings and investment. It continues to discourage savings by taxing interest income. It seriously impairs the incentive to invest in productive, but nonetheless, risky enterprises. High income taxpayers would have their tax shelter already built into a flat rate system because their marginal rates would be sharply reduced. We would expect that taxpayers would be less likely to risk their capital for such reduced tax advantages. Buying Treasury bills would become more attractive and private investment would be hurt.

The flat rate tax proposal is not a fair tax. It redistributes income away from low- and middle-income households. Taxpayers with taxable income (1981 levels) below $50,000 would pay higher taxes while taxpayers above $50,000 would pay less taxes.

TABLE 8

DISTRIBUTION OF TAX LIABILITIES UNDER A 19.5 PERCENT FLAT RATE TAX ON INCOME, LESS ZERO BRACKET AMOUNT, AT 1981 INCOME LEVELS

Expanded income (thousands)	Number of taxable returns (thousands)	Tax liability 1984 law (millions)	Tax liability flat tax (millions)	Percent change	Dollar change per return
0 to 5	6,482	403	1,574	290.7	181
5 to 10	15,[illegible]07	5,772	8,752	51.6	198
10 to 15	13,092	12,526	17,610	40.6	388
15 to 20	10,737	17,462	22,665	30.0	485
20 to 30	16,800	44,080	52,871	19.9	524
30 to 50	13,568	63,833	66,419	4.1	191
50 to 100	3,580	38,687	30,846	-21.2	-2,291
100 to 200	631	18,656	10,743	-42.4	-12,540
Over 200	164	16,385	7,129	-56.5	-56,438

a/ To facilitate comparison, 1984 law does not inclued the earned income credit, the two-earner couple deduction, or the IRA or Keogh provisions. The flat rate tax system similarly does not include those provisions.

Source: United States Congress, Joint Committee on Taxation.

The flat rate income tax proposal does not encourage homeownership. It increases the tax burdens for low- and middle-income households which would decrease homeownership opportunities for a large number of taxpayers.

It repeals the deduction for home mortgage interest and property taxes, and the one time $125,000 exclusion from taxation from the sale of a principal residence by homeowners over the age of 55. Eliminating these homeownership tax incentives would sharply increase tax liabilities for low- and middle-income homeowners. Many families could not qualify for a mortgage under existing rates without the tax incentives in the current law. Under a flat rate tax system, the homeownership rate would likely decline even further than what is now forecast.

TABLE 9

COMPARISON OF TAX LIABILITIES, SIMPLE FLAT RATE TAX AND
CURRENT LAW, FAMILY OF FOUR, FILING JOINTLY
(dollars, taxable year 1983)

		Homeowners		
		Low Income ($20,000)	Middle Income ($35,000)	High Income ($70,000)
	Flat rate tax liability a/	$2,219	$5,069	$11,719
Minus:	Current law tax liability	1,093	3,317	10,784
Equals:	Change in tax liability	1,126	1,752	935
	Percentage change	103.0	52.8	8.7

a/ Simple flat rate tax system proposed by Senator DeConcini. Marginal tax rate is 19 percent.

b/ For low-income homeowner, tax liabilitity based on a home price of $55,000, 80 percent financing with a 30 year mortgage at 13.50 percent. For middle-income homeowner, same financing assumptions based on a home price of $75,000. For high-income homeowner, same financing assumptions based on a home price of $150,000.

Source: NATIONAL ASSOCIATION OF REALTORS®, Economics and Research Division.

The repeal of homeownership tax incentives would also depress the value of residential property which, while significant for all homeowners, could be a major financial setback for the elderly or those about to retire, who have counted on a sale of the family home to produce retirement income. Almost 85 percent of the elderly are homeowners, and almost 80 percent of their total net assets are tied up in homeownership. Homeownership reduces the need for growth in government mandated retirement programs such as Social Security. A decline in residential property values would clearly increase political and financial pressures on government retirement programs.

TABLE 10

NET ASSETS FOR HOMEOWNERS OVER 65 YEARS OLD
(1977 data)

TOTAL NET ASSETS	$21,600
Home equity	$17,000
Other assets	$ 4,700
HOME EQUITY AS A PERCENT OF NET ASSETS	78.7

Source: F. Thomas Juster, "Current and Prospective Financial Status of the Elderly Population", in Saving For Retirement, ed. by Phillip Cagan, Columbia University Graduate School of Business, 1981, pp. 35-56.

The flat rate tax system in all likelihood would not simplify current tax laws. It may eliminate some complexity and inequity, but it would introduce a host of new ones. Complicated transition rules and regulations would have to be devised to cover most transfer payments and the hundreds of fringe benefits which are now excused from taxation. How simple, therefore, would a simple flat rate tax system really be? Which transfer payments and fringe benefits should be taxed, when should they be taxed, and how should they be valued?

Modified Flat Rate Tax

The Bradley-Gephardt (B-G) and Kemp-Kasten (K-K) tax proposals are modified flat rate tax systems which try to correct some of the problems of the simple flat rate tax. The essential feature of the two plans is to broaden the income tax base by discontinuing most deductions, exclusions and credits and simplifying the tax rate structure. The B-G plan proposes four marginal tax rates of 14, 20, 25, and 28 percent while the K-K plan uses a flat rate of 25 percent.

The list of provisions retained in both plans is similar and are those which are most popular with low- and middle-income taxpayers. For instance, both plans retain deductability of mortgage interest and property taxes, of IRA and KEOGH contributions, and the charitable deduction. Kemp-Kasten retains a commitment to index the tax system so that inflation would not push taxpayers into higher brackets while Bradley-Gephardt discontinues indexation.

What is disappointing about both Bradley-Gephardt and Kemp-Kasten is that neither improves very much the tax structure as it pertains to savings and investment while both would discontinue many existing tax incentives which encourage certain types of savings and investment. Both plans continue to rely heavily on personal income taxes as a source of government revenue. Both plans continue the bias against personal savings by taxing them twice--once when the money is earned, and again when it produces income in an interest-earning investment. Both plans repeal the investment tax credit but K-K retains the current depreciation provisions while B-G would end accelerated cost depreciation allowances, thus significantly lengthening the time over which rental property could be depreciated. Both plans eliminate all tax credits for the preservation of historic and other buildings, and end tax exemptions for locally issued mortgage bonds. In short, both plans thoroughly eliminate many important and worthwhile investment incentives. Repealing them would have a severe adverse effect on investment in general, and real estate in particular.

Bradley-Gephardt would limit the applicability of itemized deductions (including home mortgage interest) to the lowest bracket rate of 14 percent while disallowing these deductions for the upper bracket rates of 20, 25 and 28 percent. For taxpayers in these brackets, mortgage interest and other popular deductions retained would thus become taxable at from 6 to 14 percent. Each dollar of deductions, therefore, would be worth only 14 cents in the B-G tax system compared to a maximum of 50 cents in the current system. Because of this change, homeownership tax savings in the B-G system would be 40 to 70 percent less than the savings in current law (see Table 11).

Technically, Kemp-Kasten also limits the applicability of itemized deductions to a 25 percent marginal rate because it uses a single flat rate. However, the K-K plan allows an "employment income credit" of 20 percent up to the FICA maximum wage base (about $40,000 in 1984). For low- and middle-income taxpayers, it is an additional exemption which rises with income. The employment income credit is phased out for taxpayers earning more than the FICA maximum wage base (e.g., those earning more than $100,000 in 1984 would receive no credit). The impact of this provision is to increase homeownership tax incentives for low-income taxpayers by about 45 percent (and the value of other itemized deductions retained), keep it about the same for middle-income taxpayers, and decreases it almost 40 percent for high-income taxpayers (see Table 11).

TABLE 11

COMPARISON OF HOMEOWNERSHIP TAX SAVINGS, BRADLEY-GEPHARDT, KEMP-KASTEN AND CURRENT LAW, FAMILY OF FOUR, FILING JOINTLY
(dollars, taxable year 1983)

		Low Income ($20,000)	Middle Income ($35,000)	High Income ($70,000)
	B-G tax savings	$ 462	$ 931	$2,506
Minus:	Current law tax savings	758	2,055	7,826
Equals:	Change in tax savings	-296	-1,124	-5,320
	Percentage change	-39.1	-54.7	-68.0
	K-K tax savings	$1,100	$1,937	$4,750
Minus:	Current law tax savings	758	2,055	7,826
Equals:	Change in tax savings	342	-118	-3,076
	Percentage change	45.1	-5.7	-39.3

a/ For low-income homeowner, tax liabilitity based on a home price of $55,000, 80 percent financing with a 30 year mortgage at 13.50 percent. For middle-income homeowner, same financing assumptions based on a home price of $75,000. For high-income homeowner, same financing assumptions based on a home price of $150,000.

Source: NATIONAL ASSOCIATION OF REALTORS®, Economics and Research Division.

Consumed Income Tax

Simple and modified flat rate tax proposals do little to correct the bias against savings and investment in current law. An alterntive model for tax reform is a tax on the amount of income consumed, rather than on the amount of income earned. A consumed income tax system, depending on how it is designed, could be a powerful way to increase savings.

There are four distinct ways to tax consumption: (1) an income tax with deductions for saving and investment; (2) a retail sales tax administered on a national basis; (3) a value-added tax charged on the amount that each stage in the productive process adds to the final value of goods and services; and (4) a direct tax on people's consumption expenses, also known as an expenditure tax. The last alternative is very complicated, administratively difficult because few people keep such records or could reliably be forced to, and poses serious transitional problems.

An income tax with deductions for savings and investment, however, is a feasible and effective way to increase savings. This version of the consumed income tax is not a radical departure from current law. Indeed, recent tax reform has been slowly moving in this direction. The adoption of accelerated cost recovery in 1981 moved the tax treatment of business investments in machinery and equipment much closer to the treatment required under a consumed income tax. Provisions that allow expensing of certain capital investments and rules that permit most costs of research and development to be expensed rather than capitalized are consistent with a consumed income tax. The introduction of KEOGH, IRAs, other interest tax exemptions, and lower tax rates on capital gains are other examples of taxing consumed income rather than earned income.

Tax reform should continue moving in this direction. Income invested in a savings account or any other savings instrument should not be taxed until it is withdrawn and spent.

An income tax with deductions for savings and investment would attract wide support and would have significant economic benefits. The stigma of regressivity is removed by making use of progressive tax rates in the current law. A larger pool of savings would provide lower-interest mortgage money to help the young finance their homes which would improve the economy and the nation's homeownership rate. Middle-aged and middle-income families would be able to save more for their children's education. More savings would help the unemployed by creating new jobs by increasing the competitiveness of U.S. products and services in world markets.

A version of the consumed income tax is a national sales tax administered at the retail level. A national retail sales tax has numerous advantages. It is relatively easy to administer. Saving and investment income are exempt automatically. It can be imposed quickly with little disruption to the present tax system. Public acceptance of the tax would assure a strong and politically stable base. And, it is a powerful revenue raiser (in 1984 it would raise about $25 billion dollars per percentage point).

The national sales tax, however, has many disadvantages. If a major consumer purchase such as a home were taxed at the retail level, it could cause an enormous redistribuion of wealth away from homeowners, and it could increase the price of property beyond the financial means of many families. A national sales tax applied to the purchase of a home would clearly have a negative impact on the homeownership rate and economic growth.

A national sales tax could increase inflation if it were included in official price indexes and if it induced no significant reductions in non-taxed prices. Investment would be adversely effected because depreciation is

A national sales tax, either at the retail level or at the production level, is merely another device for increasing reliance on consumption taxation. As discussed above, there are advantages (less taxation on savings and investment) and disadvantages (regressivity and inflation) which are not easy to resolve.

Alternatively, it may be more efficient, feasible and less disruptive to increase existing provisions in the current income tax under which savings and investment are excused from taxation, such as the deferral of taxation on pensions funds, IRAs and KEOGH plans. In principle, the extension of such deferral arrangements and the creating of new ones would continue to convert the current tax system into a graduated tax on income less savings.

undervalued by inflation. Also, higher inflation would increase market interest rates in general and adjustable rate mortgages in particular which now account for a large share of the mortgage market.

A national sales tax would have other importantant disadvantages. It could encourage more wasteful government spending by taxing citizens at lower rates so they wouldn't realize they were paying more tax. It is a regressive tax that falls more heavily on lower-income households because they, of necessity, spend more of their income (although use of exemptions, differential rates, and a refundable income tax credit could offset the regressivity of a sales tax). It could erode an important tax base of State and local governments.

Another version of the consumed income tax is the value-added tax (VAT) levied at each stage of the production process, not on gross sales or net income, but on the value added to the materials and supplies used in production at that stage. Many European countries use versions of the value added tax, and there are important lessons that can be learned from them.

All of the VAT systems in Europe treat investment exactly as they treat purchases of current inputs. This allows immediate deduction from sales the full value of investments made during the taxable period. Evidently the Europeans have learned that a consumption type pro-investment VAT system is superior to any other type of system that may discourage investment.

All European nations exempt certain commodities for the value-added tax such as the services of owner-occupied housing, "social" goods such as health services and education, and banking and financial services which are difficult to value. Severe transitional problems arise if housing is subject to a VAT.

There are also regressivity and inflation problems associated with a valued-added tax for the same reasons these are problems with a national sales tax.

The NATIONAL ASSOCIATION OF REALTORS® is comprised of more than 1,806 local boards of REALTORS® located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is over 600,000 persons actively engaged in sales, brokerage, management, counselling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums. The Association has the largest membership of any association in the United States concerned with all facets of the real estate industry.

Elected officers are: President Donald H. Treadwell, Southgate, Michigan; President-elect David D. Roberts, Mobile, Alabama; First Vice President Clark E. Wallace, Moraga, California; Treasurer Phillip C. Stark, Madison, Wisconsin.

The Chief Administrative Officer is Jack Carlson, Executive Vice President and Chief Economist.

The Senior Vice President, Government Affairs is Albert E. Abrahams and the Vice President and Legislative Counsel, Government Affairs is Gil Thurm.

Headquarters of the Association are at 430 North Michigan Avenue, Chicago, Illinois 60611. The Washington Office is located at 777 14th Street, N.W., Washington, D.C. 20005. Telephone (202) 383-1000.

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STATEMENT OF JOHN O'BRIEN, CHAIRMAN, EXECUTIVE COMMITTEE, MUNICIPAL SECURITIES DIVISION, PUBLIC SECURITIES ASSOCIATION, WASHINGTON, DC

Mr. O'Brien. Mr. Chairman, thank you. In additon to being chairman of the PSA's Municipal Securities Division, I am also a managing director at Salomon Bros., in charge of the municipal bond department. PSA is a national trade association of some 300 dealers, dealer banks, and brokers, active in the markets for State and local governments, U.S. Government, and mortgage-backed securities. Thus, we are concerned both professionally and individually with tax reform. We should thank the committee for the opportunity to testify this afternoon, and wish to commend you, Mr. Chairman, as well as the members of this committee for your efforts to make the tax system more simple, equitable, and economically efficient. I volunteer the full cooperation of the PSA, its members, and staff in this effort. The point of my written statement is that tax reform that impedes the ability of State and local governments to efficiently provide services as well as build and maintain essential public facilities would be contrary to the spirit of the new federalism and may accelerate the displacement of the economic burden of the Federal budget deficits to the State and local levels.

Eliminating or diluting the value of the tax exemption on municipal securities would certainly raise the cost of State and local governments, and would threaten their independence. Tax exemption must be preserved. Today, I offer you and the committee the resources of the investment community throughout the duration of your deliberations on tax reform. Thank you, Mr. Chairman. Mr. O'Connell?

The Chairman. Thank you, Mr. O'Brien.

[Mr. O'Brien's prepared written statement follows:]

STATEMENT OF JOHN J. O'BRIEN*

ON BEHALF OF

THE PUBLIC SECURITIES ASSOCIATION

INTRODUCTION

The Public Securities Association (PSA) is pleased to participate in the Senate Finance Committee hearings on major tax reform options. We commend the Committee for its efforts to rationalize our Nation's tax system by making it more equitable, simple and economically efficient. PSA is prepared to assist the Congress in this important endeavor.

Our comments will address the likely effects of major tax reform measures on the financial integrity of state and local governments; particularly with respect to their continued ability to issue tax exempt securities pursuant to state law. We urge the Committee, in its consideration of the various proposals before it, to deliberately and carefully examine both their direct and incidental impact on states, local governments and their citizens. We believe that the tax exemption on state and local government securities must be preserved, regardless of the ultimate decision that this Committee and the Congress reach on tax reform.

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*Mr. O'Brien, who is Managing Director at Salomon Brothers Inc., is Chairman of the Municipal Securities Division and a member of the Board of Directors of the Public Securities Association.

PSA is the national association of dealers, dealer banks and brokers active in the markets for state and local government securities, U.S. Government and federal agencies securities, and mortgage-backed securities. Our nearly 300 member firms are located in all 50 states. Last year, our members participated in over 95 percent of the dollar volume of new issues of state and local government securities. These same firms also account for the vast majority of secondary market trading activity in these securities. Our membership participates in the full range of dealer activities, and includes small firms dealing in special assessment issues and local financings, multi-million dollar investment banking powers, full service national wire houses, major money market center and regional dealer banks. Our membership also includes approximately 100 associate members (such as bond counsel, accounting firms, and clearing corporations), whose activities are closely related to the municipal bond market.

As an Association composed of securities dealers and dealer banks who will continue to act as financial intermediaries for the states and their political subdivisions, regardless of the continuity of the tax-exemption, we urge you to consider the consequences of any further undermining of state and local government's ability to issue tax-exempt obligations.

REFORMING THE FEDERAL TAX CODE

We recognize the magnitude of the challenges faced by Committee members in reforming the tax code. Consequently, we are appreciative of their sincere concern for the individuals and institutions that may be affected by enactment of major tax reform legislation. However, to be most effective, this effort must be accompanied by a reduction in the growth of Federal expenditures. PSA supports enactment of tax code changes which would stimulate savings and investment in conjunction with the adoption of a Federal budget which would restore the public's confidence in the government's ability to control the growth of federal spending. Moreover we are in accord with the statement of Chairman Dole that,

> We may agree on general goals for tax policy, but how you proceed makes a great deal of difference to the taxpayer and the economy.

Our statement today is intended to alert members of this Committee to the impact of major Federal income tax reform on state and local governments and their taxpayers as well as, the effects of tax reform on the market in which state and local governments borrow critically needed funds. Making the system of Federal taxation more equitable must not be accomplished by raising the cost of carrying on state and local government. It would be a Pyrrhic victory if Federal tax reform were simply to shift tax burdens from the Federal government to the states, their political subdivisions and their citizens. From the citizen's and voter's perspective, it is the total tax burden which matters.

THE FISCAL RESPONSIBILITY OF STATE AND LOCAL GOVERNMENT

States and localities in 1984 are expected to expend more than $380 billion on services and facilities. This sum is equal to 40 percent of the total Federal budget or 60 percent of the non-defense Federal budget.

However, the sources of funds available to states and localities are limited and have been buffeted by the economic and political events of the recent past.

States and localities typically finance their activities through three sources of revenue:

1. Taxes;
2. User fees; and
3. Transfer payments from other levels of government.

States and localities are reaching the upper limits of their economic ability to tax. Much like the Federal government, these levels of government have been directed by their citizens to maintain current levels of taxation or even, in certain instances, to lower them. Similarly, they have met widespread resistance to increases in user fees which finance certain services and institutions.

Further, the size of the Federal deficit--in conjunction with a changed perception of the role of the Federal government as a supplier of financial support--has resulted in a $42 billion reduction over the last three years in Federal grants to states and local governments. Not surprisingly, local governments have also experienced a reduction in grants from state governments. Thus, revenue derived from transfer payments from one level of government to another have declined in real terms.

In short, states and localities have experienced increasing pressures on all three traditional sources of funds to finance the range of services which citizens expect from these levels of government. Furthermore, this pressure on the revenue side has intensified precisely at a time of both pent-up demand for services and an increase in the total cost of such services: a shrinking pool of dollars in the face of increasing number and scale of competing demands.

We wish to focus your attention especially on one important set of these demands--the building and maintenance of our nation's basic infrastructure; that is, the water systems, roads, bridges and schools--generally--the network of capital facilities, which bind our country together and facilitate our day-to-day activities as well as the commerce of our communities and the nation as a whole.

The basic responsibility for creating and maintaining these capital facilities we call the infrastructure has traditionally been lodged and continues to reside at the state and local levels of government. Furthermore, our citizens like it that way. In a recent survey of tax-paying homeowners in cities as diverse as Minneapolis, Tulsa, Rochester (N.Y.) and San Francisco nine out of ten respondents cited their state, county and local governments as the "best provider" of these essential public services.

The principal financial tool by which states and their political subdivisions provide these services is to borrow in the capital markets through the sale of tax-exempt, fixed-income obligations which are repaid from taxes and user fees. Investors accept significantly lower interest rates on these state and local bonds only because the income from them is exempt from Federal taxes. In the absence of this exemption from Federal income taxes, investors would demand yields on state and local securities which are comparable to equivalent taxable instruments, at roughly 3.25 percent above current tax exempt rates.

The value of this preeminent mechanism through which states and localities fulfill their responsibility for the nation's "capital plant" is all the more important when the need is considered. We as a Nation, are currently facing a crisis with our existing infrastructure as public facilities crumble before our eyes. To cite only one example, fully half of the nation's bridges are believed to be structurally deficient. In addition, population growth and shifts from some parts of the country to others are placing enormous demands on state and local governments for expansion of even relatively new infrastructure.

This year, state, county and municipal governments will spend a combined total of more than $46 billion from their own resources on government-owned capital projects demanded and expected by the public. Over the next ten years, however, it is conservatively estimated that combined state, county and municipal spending for local infrastructure construction and repair must increase radically. Considering only those basic facilities owned and operated by state and local governments we estimate an annual capital need which is 52 percent higher than the current level.

If we exclude from consideration that portion of the capital need which is likely to be supported from Federal grants--as well as that portion which may be provided on a "pay-as-you-go" basis from current state and local revenues--we expect borrowing to meet that need to total at least $337 billion over the next six years. This estimate also excludes an additional $100 billion required for such things as subsidized multi-family housing, solid waste treatment, public power and non-profit hospitals where the state and local government does not own the facility.

If the amount required only for publicly owned facilities is financed with tax-exempt bonds having an average life of 20 years at the prevailing interest rate of about 10.00 percent, total interest payments by states and localities on that debt will measure approximately $674 billion. The cost to states and localities of the same securities at taxable rates of, say, 13.00 percent would be approximately $220 billion more for a total cost of capital and interest of $1.2 trillion. The added cost of financing in the taxable market would require states and local governments to increase taxes or cut expenditures by $11 billion a year.

CURRENT PROPOSALS FOR TAX REFORM

In recent years, the effectiveness of tax-exempt financing as a tool for state and local governments has already been diminished by a series of Federal legislative actions. The Congress has consistently pursued a policy of challenging and narrowing the scope of the tax exempt market. This has forced the market to deal with uncertainty almost on a continuous basis. Markets work least efficiently in this type of environment. Among these Congressional actions we wish to cite the most significant:

1. Inclusion of tax-exempt interest income in the calculation of social security recipients' taxable income which challenges to the continued ability of states and localities to issue tax-exempt securities and seriously threatens investors' reliance on the continuity of the tax-exemption;

2. Enactment of the Deficit Reduction Act of 1984 which imposes an artificial "cap" on the volume of certain securities and challenges the right of states to determine the types of public purpose facilities that may be financed by tax-exempt securities;

3. Changes in the tax-code that have created additional competitive investment vehicles which share the tax-exemption with state and local governments securities (e.g. IRA's, Keogh, Self-retirement plans, the "All-Savers" certificate).

Our concern is that Congress, in considering Federal tax reform, also carefully consider the impact of the various proposals on state and local government finance. This can be accomplished best by segregating the proposals into two categories by type. Firstly, development of a broad based or giant step tax, reducing both the number of tax brackets and the magnitude of allowable exemptions from taxation while broadening the tax base generally. Second, is development of a consumption tax, based on taxpayer spending or the amount of value added to a product during its manufacture or processing.

It should be noted that these proposals would effect the economy and all capital markets in a multitude of ways. It is beyond the scope of this statement to address these macroeconomic issues. Rather, this statement will only review a number of the direct effects of current proposals on state and local government securities.

The category of broad based taxes includes the FLAT tax, the FAIR tax (S. 1421) proposed by Senator Bradley and Representative Gephardt, and the FAST tax (S. 2600) sponsored by Senator Kasten and Representative Kemp. These taxes could have deleterious effects on state and local government securities.

The proposals to establish a broad based tax could directly affect the issuance of tax-exempt securities. The FLAT tax would totally eliminate the tax exemption. Such a result would be in contravention of the Constitutional doctrine of reciprocal immunity. In Pollock v. Farmers Loan and Trust Co., the U.S. Supreme Court ruled that the doctrine of reciprocal immunity protects interest earned on state and local government securities from Federal taxation just as interest earned on U.S. Government securities is immune from state and local government taxation. Elimination of the tax exemption would cause a grave fissure in our Federalist system of government, as states and their subdivisions may well be unable to finance necessary infrastructure projects.

The FAIR tax and the FAST tax would eliminate the tax-exemption for a large number of public purpose securities. They would end the issuance of tax-exempt bonds for industrial development, single family mortgages, student loans, and bonds issued on behalf of charitable organizations as defined in I.R.C. Section 501(c)(3). Such an approach also would eliminate the tax-exemption for securities issued to finance infrastructure public purposes such as airport and port development, public power projects, and mass commuting facilities. Limiting the tax exemption in this manner would directly increase state and local government financing costs for these essential projects.

The broad based tax proposals also would limit the attractiveness of tax-exempt securities to investors. Reducing the highest marginal tax rate from 50 percent to 30 or 25 percent will generally reduce the value of the tax exemption. This reduction would result in a narrowing in the differential between the yields on tax-exempt and taxable securities.

Moreover, this effect would be more pronounced should S. 1421 be enacted. This proposal would apply the tax exemption at the 14 percent marginal rate. At this relatively low level, the value to an investor of the tax exemption would be greatly reduced.

However, by eliminating a number of the exemptions and tax shelters that compete in the market with municipal securities, these provisions may ameliorate some of the negative effect that would result from lowering the marginal rates. It is difficult to determine the exact effect that this countervailing consequence of a broad based tax would have on the market.

An additional difficulty with a broad based tax concerns its implementation. Should such a tax be enacted, fairness would seem to require the establishment of a transition rule providing for adequate protection of the value of securities held by investors. The purchaser of a tax-exempt state or local government obligation accepts the lower return on such an investment assuming that the tax laws will not be fundamentally altered. To destroy this trust would wreak havoc with the retirement plans of millions of investors. In addition, without prior assurance that adequate transition rules will be adopted, the market for state and local government securities issued prior to the passage of a broad based tax would be wrought with uncertainty resulting in greatly increased borrowing costs for states and localities even prior to its enactment.

Consumption taxes are based on spending or the value added to a product rather than the acquisition of income. Examples of such a tax are the Value Added Tax (VAT), a National Retail Sales Tax or S.5841, the consumption tax introduced by Senator Heftel. By focusing on consumption, these taxes would render the tax exemption on state and local government securities less relevant. Should a consumption tax replace the Federal income tax the tax-exemption on state and local government obligations would be _de facto_ eliminated. However, should a consumption tax be implemented along with an income tax, we would expect the value of the tax exemption to remain fundamentally unchanged.

While its effect on the market for state and local government securities may be limited, we fear that enactment of a consumption tax may have a deleterious effect on state and local government tax policy. Such taxes would compete with the sales taxes now utilized by states and localities and would raise the prices paid by consumers for products.

PSA is continuing to study the effect of these proposals on state and local governments and would be pleased to share its further findings with the Committee.

CONCLUSION

We are in the midst of a critical national debate regarding the proper relationship between Federal expenditures and Federal revenues. PSA members, as dealers and bankers in fixed-income securities, understand that a proper resolution of this is essential for the continued health of all capital markets.

Our comments today are intended to inform the Committee of the financial responsibilities currently facing our Nation's states and their political subdivisions, as well as, to alert the Committee to the potential harmful effects of a number of the tax reform proposals on the ability of states and localities to borrow in the capital markets with tax-exempt securities.

We are aware that many of the implications of the proposals cannot be fully evaluated at this time. We, therefore, urge the Committee to very carefully consider the results of any fundamental tax law changes on our Nation's states and localities and to the market in which they borrow critically needed funds. Tax reform that annhilates our Federalist system of government or raises the burden of taxpayers at the state and local level would be counter-productive. We support tax reform that maintains the balance of Federalism and includes the right of state and local governments to issue tax-exempt obligations.

STATEMENT OF BRIAN O'CONNELL, PRESIDENT, INDEPENDENT SECTOR, WASHINGTON, DC

Mr. O'CONNELL. Mr. Chairman, it is important in talking about charitable contributions, particularly in any relationship to tax policy, to make absolutely clear that a desire to help others—the altruism—is the reason why people contribute to charities. The tax deduction is not why people give. Because it has been in place for quite some time, the tax deduction does influence the size of many gifts now on the order of approximately 25 percent of the total of all giving. Tax reform designed for entirely other purposes must not inadvertently undercut that influence—that 25 percent of all giving. Independent Sector has commissioned research on the impact on charitable contributions of all of the major proposals for tax reform and tax simplification. We will certainly provide those findings to this committee. We already have the report on the FLAT tax reform proposals, most of which, as you know, don't include an exception for charitable contributions. We found that unless there are provisions for charitable deductions, contributions will be reduced by 26 percent. Even the Bradley-Gephard bill, which retains the charitable deduction, would decrease giving by approximately 13 to 14 percent. We don't pretend to be tax experts, but we do know what nonprofit endeavor means to the kind of country, the kind of people we are. Tax reform must not eliminate or reduce the current levels of encouragement for charitable giving. Any such move would contradict the larger public policy in place from the start which has been to foster the giving and pluralism that are so such an important part of America's uniqueness.

The CHAIRMAN. Thank you. Mr. Bowen?

[Mr. O'Connell's prepared written statement follows:]

INDEPENDENT
SECTOR

Testimony of Brian O'Connell

President, INDEPENDENT SECTOR

on

Tax Reform and Charitable Contributions

before the

Senate Finance Committee
Room 215 Dirksen Senate Office Bldg.
August 7, 1984

Introduction

My name is Brian O'Connell. I am President of INDEPENDENT SECTOR, a membership organization of 574 national voluntary organizations, foundations, and business corporations which have banded together to strengthen our national tradition of giving, volunteering and not-for-profit initiative.

Our Voting Members are organizations with national interest and impact in philanthropy, voluntary action and other activity related to the independent pursuit of the educational, scientific, health, welfare, cultural and religious activities of the nation. The range of members includes the American Heart Association, United Negro College Fund, Goodwill Industries of America, National Council of Churches, Native American Rights Fund, Council on Foundations, American Association of Museums and National Puerto Rican Coalition. The common denominator among this diverse mix of organizations is their shared determination that the voluntary impulse shall remain a vibrant part of America.

IS Position on the Charitable Deduction in Tax Reform Proposals

The INDEPENDENT SECTOR does not take a position on the tax structure itself or the restructuring of it, but we do argue that any revisions must not eliminate current levels of incentive for charitable contributions. Any legislation that does not provide a continuation of those encouragements would be opposed by INDEPENDENT SECTOR.

Prior and New Research on the Charitable Deduction

We already know that people give to the causes of their choice because they want to help others and they want to be a part of a society that values this kind of caring and mutual assistance. These are the primary motivations for giving. It is absolutely essential that all concerned know that taxes are not a motivation for giving and that the tax deduction does not influence the number of gifts people make.

It is equally important to know that the tax deduction does influence the size of gifts and thus the total amount of giving.

Surveys commissioned by INDEPENDENT SECTOR and undertaken by the Gallup Organization make clear that the availability of the tax deduction does not influence the number of gifts an individual makes. However, it does influence the size of those gifts particularly for individuals who use the charitable deduction. Those studies show that in every income bracket, itemizers gave significantly more than nonitemizers. On the average, itemizers gave 2 1/2 to 3 times the nonitemizers' amount.

Dr. Martin Feldstein, Harvard economist and President of the National Bureau of Economic Research, testified in 1980 before this Committee that his research clearly demonstrates, "the deduction of charitable contributions in the calculations of taxable income lowers the 'price' of giving and stimulates increased amounts of giving." He went on to point out that there would be a substantial drop in charitable contributions if they were not tax deductible.

In an article "Income Tax and Charitable Contributions" (Econometrica, Vol. 44, No. 6 - November, 1976) Feldstein and Taylor stated "Consider first the implications of completely eliminating the deduction without substituting any other provision that encourages charitable giving. The simulation indicates that this would reduce total giving in 1970 from $17.3 billion to $12.8 billion, a decrease of 26 percent. Eliminating the deduction also increases total tax revenue by $3.5 billion. This implies that the current deductibility induces $1.29 of additional charitable giving per dollar of revenue lost."

The evidence is beginning to come in on the results of lowering the upper tax table from 70% to 50% and it looks likely that the size of gifts and total giving of people in that bracket are down significantly.

INDEPENDENT SECTOR is currently conducting research on the impact on charitable contributions of the various tax reform proposals, such as flat tax, value added tax, consumption tax, and similar proposals. We will provide information from that research to this Committee in the Fall.

We already have the report on the impact of the various flat tax proposals. This is part of the work being done for INDEPENDENT SECTOR by Dr. Charles T. Clotfelter of Duke University. Most of the flat tax proposals do not make an exception for the charitable deduction. Dr. Clotfelter found that unless compensatory provisions for charitable contributions are included in flat tax proposals, individual contributions will be reduced by 26%, or $12.1 billion annually. Even the Bradley-Gephardt flat tax proposal which retains the charitable deduction would cause a serious decline of 13% in charitable giving. That bill, the most generous of all flat tax measures in its treatment of charitable contributions, would require that the charitable deduction be increased by 250 percent to keep giving at its current level. This makes clear that the changes in the tax law need to make an exception for charitable contributions and need to contain provisions that will encourage at least current levels of charitable support.

Failure to exclude the charitable deduction in the other flat tax proposals is in part a failure to understand the vital role of voluntary organizations in our society, and to understand the importance of the charitable deduction as an influence on the size of gifts.

The Importance of Voluntary Organizations to Our Society

Voluntary organizations supported by charitable contributions are indispensable to our way of life.

--They provide many services at little or no cost, which would otherwise have to be provided by government at full cost to taxpayers.

--They can and do espouse unpopular causes, minority viewpoints, and are free to fight inequity and injustice.

--They engage in activities which, under our way of life, neither the profit sector nor government should get into.

--They promote "watchdog" functions, which can be performed best by nonprofit groups.

--They are free to explore, to experiment, to innovate, to try -- and to fail. Many of today's essential government functions are yesterday's volunteer innovations.

--They have been responsible for virtually every significant social change in the past century. They include abolition of slavery and women's suffrage, and they include those who led the way on child labor laws, the civil rights movement, protection of the environment --all these and many more.

In no other country in the world are individual giving and volunteering for public purposes so pervasive and powerful a part of national life as they are in the United States.

History of Tax Exemption and Deduction

Historically, tax policy has encouraged the development of voluntary organizations. From the earliest beginnings of our country, deliberate effort has been made to encourage private initiative for the public good and to promote and sustain the voluntary institutions through which the nation does so much of its public business. Those conscious efforts included the property tax exemption and, when the modern day Federal income tax was adopted, the charitable contributions deduction. To reverse that direction now -- for whatever intended good purpose -- would dangerously overlook the larger value of our unique degree of voluntary participation.

The action of Congress in 1917 to provide for the charitable contributions deduction was a clear indication of our determination as a society that we wanted to find every conceivable way to encourage pluralism and maximum possible involvement of citizens in addressing their own problems and aspirations. Passage of the Charitable Contributions amendment in 1981, which again allows all taxpayers, even those who use the standard deduction or short form, to deduct their contributions, was a recent and further indication of how essential it is that Americans be encouraged to support the causes of their choice.

Conclusion

The deduction of charitable gifts has provided a significant incentive for increased giving, but even more importantly has served to remind all of us that it is the philosophy and policy of the people and our government, that giving is an act for the public good that is to be fostered. These direct and indirect encouragements have helped to maintain and promote the enormous degree of pluralism and citizen participation that are among the country's most important characteristics.

The desire to do good and to improve the communities in which we live are the underlying motivations for giving. But the tax deduction helps influence the size of many gifts.

If we believe that pluralism is important in our society, then it is exceedingly important that we be searching every possible way to encourage just such behavior and certainly we should not inadvertently adopt measures that would shrink this increasingly important part of our national life.

We are not experts on tax policy, but we do know what nonprofit endeavor has meant and continues to mean to the kind of society we are. Whatever occurs as the result of current efforts related to tax reform must not eliminate or reduce the current levels of governmental encouragement for charitable contributions. Any such move would contradict the larger public policy consideration which from the start, has been to foster the vast participation and diversity that are so much a part of America's uniqueness.

STATEMENT OF WILLIAM G. BOWEN, PRESIDENT, PRINCETON UNIVERSITY, FOR AMERICAN COUNCIL ON EDUCATION, WASHINGTON, DC

Mr. BOWEN. Thank you, Mr. Chairman. Let me say first that I applaud very much the efforts that you and your colleagues are making to wrestle with what is obviously an extremely important set of issues.

The CHAIRMAN. If I could just add three examples of people who don't want to be left out of any doubt of any flat tax arrangement, and therein lies the problem. But you may have another one.

Mr. BOWEN. I am simply commending you for your courage. [Laughter.]

Nothing more substantive than that.

The CHAIRMAN. It doesn't take courage to have the hearings—it is the markup. [Laughter.]

Mr. BOWEN. I would like in this very brief summary to make four points. First, the kinds of major changes in the Tax Code that are now being considered can have very dramatic side effects—on the ways that the whole society is organized and structured, on the ways in which we live. Second, that is clearly the case--unmistakably the case—as far as higher education is concerned. I think we are all aware that it is true of private higher education, which has always depended so importantly on private gifts. It is also very powerfully the case for public higher education and increasingly so. The third point that I would make is that while there is uncertainty as to economic effects in a number of areas, there is astonishing—agreement in a field not characterized by astonishing agreement—that the tax incentives now in place make an enormous difference, not just to charitable contributions generally—though they certainly do that—but even more so to higher education. There is, I think, no applied field of public finance that has been studied in more detail over a longer period of time than this one, and the results of the studies are quite consistent in suggesting that decreases in marginal rates—certainly the elimination of the charitable deduction--would have dramatic effects on the overall level of support for higher education. My fourth point is that it is extremely important that the committee deal directly with these effects.

They are just too important, in my view, to be overlooked. This country is unique in its system of higher education, and I would hope that before altering significantly incentives to give, the most careful consideration would be given to patterns in other countries. What we are talking about here is the service of national objectives, and what is really at issue, I think, is whether they are to continue to be served in this country by a mix of private and public sources or through public sources largely alone. The effects of a movement in that direction would, I think, be extremely deleterious to the country as a whole, to the national interest. I am reassured, Mr. Chairman, by these hearings that you will not do inadvertently what I think no one of us would do intentionally. Thank you.

The CHAIRMAN. Thank you.

[Mr. Bowen's prepared written statement follows:]

TESTIMONY

TO THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

AUGUST 7, 1984

PRESENTED BY

WILLIAM G. BOWEN

PRESIDENT

PRINCETON UNIVERSITY

ON BEHALF OF

American Association of State Colleges and Universities
American Council on Education
Association of American Universities
Association of Catholic Colleges and Universities
Association of Jesuit Colleges and Universities
Association of Urban Universities
Council of Independent Colleges
National Association of College and University Business Officers
National Association of Schools and Colleges of the United Methodist Church
National Association of Independent Colleges and Universities
National Association of State Universities and Land-Grant Colleges

Mr. Chairman and Members of the Committee:

My name is William G. Bowen, and I am Professor of Economics and Public Affairs and President of Princeton University. I am appearing here today on behalf of the American Council on Education, the National Association of Independent Colleges and Universities, the Association of American Universities and the other associations listed on the cover sheet of my testimony. The ACE is the most all-encompassing organization of its kind in America, its members numbering more than 1700 colleges, universities, and other organizations in higher education. NAICU, the "voice of independent higher education" is composed of over 800 nonprofit private colleges and universities, while the fifty American members of the AAU include almost all of the major research universities of the nation, both public and private.

I appreciate the opportunity to present these views, and I commend the Committee for beginning now what should be a sustained and systematic effort to understand the implications of proposals to restructure the way in which we collect taxes in this country. Some of the leading proposals represent dramatic departures from the existing system that has grown up around the core of the progressive income tax. That system, whatever its advantages and disadvantages might be in theory or in practice, has had pervasive effects on essentially all aspects of American life. Institutions, policies, and practices that seem to be a quite natural part of our society, and that are generally taken for granted, are in fact artifacts of the incentives -- and disincentives -- which that tax system has offered. Thus, in considering truly fundamental changes in the tax system, this Committee is not simply evaluating technical problems of economics or finance. It is contemplating changes that almost certainly would have profound effects on the ways in which we serve national objectives.

This is emphatically the case with higher education, and while it would be foolish to suggest that the shape of the tax code should be dictated by concerns for any one set of activities (even one as vital, in my dispassionate eyes, as education and research), I think it would be equally mistaken to alter fundamentally the existing tax system without dealing directly with the implications of such changes for higher education. They are far too important to be overlooked or set aside.

While any tax code -- the present tax code or the new tax codes under consideration -- will affect higher education in a great many ways, I want today to concentrate on the single most important avenue of impact: the incentives for private donations.*

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*Other critical questions are sometimes definitional: whether graduate student stipends, for example, are regarded as taxable income, and whether, under a consumption tax, tuition payments would be regarded as "consumption." It is hard to discuss these questions, important as they are, in the abstract. But I do want to call attention to their importance.

The dollars involved are substantial by any reckoning. In 1982-83, total voluntary support for institutions of higher education amounted to $5.1 billion. Gifts directly from individuals represented 47% of the total ($2.4 billion) and gifts from living individuals -- the category of gifts most responsive to changes in tax incentives -- constituted 71% of individual gifts.

The dependence of private colleges and universities on such gifts is widely appreciated. What is less well known is that in 1982-83, gifts to public four-year institutions constituted 31% of total giving to higher education, and grew from the previous year at a rate nearly three times the rate of growth of giving to private institutions. Increasingly, then, the health of many of our institutions of higher learning -- public as well as private -- depends on their ability to attract private donations.

It would be depressing in the extreme if taxes were the only or even the dominant influence on individual decisions to give, and there is no evidence that that is the case. But it is certainly true that they are a highly significant factor. And it is equally clear that the major tax policy instrument affecting individual giving is the charitable deduction allowed in the calculation of taxable income for taxpayers who itemize their deductions.

The strength of the incentive effect created by the charitable deduction of course varies directly with the marginal tax rate; at a 25% marginal rate, the net cost to the taxpayer of a $1,000 gift is $750, whereas at a 50% marginal rate the net cost of the same gift is $500. The economic studies of this relationship are remarkable for the consistency of their findings. Charitable giving is highly responsive to its net cost, and a ten percent rise in the net cost can be expected to cause at least a ten percent drop in charitable contributions.* Moreover, it appears that the degree of responsiveness increases somewhat with income, i.e., donors in the upper income groups, the groups that are most likely to contribute to colleges and universities, are even more sensitive to changes in the net cost of giving than are others. Recent Treasury Department data suggest that decreases in the size of charitable contributions of up to 30% in the highest income brackets accompanied the lowering of the top bracket rates in 1981.

In an earlier study done for the Filer Commission, Martin Feldstein estimated that complete elimination of the charitable deduction in 1970 (with the marginal rates then in effect) would have reduced total charitable contributions on the part of those who itemize deductions by 26% and would have cut gifts to educational institutions by almost half. More recently, Charles Clotfelter has studied several flat tax proposals that retain a charitable deduction but nonetheless raise the net cost of giving very significantly by lowering the marginal tax rate. (For example, under a flat tax of 14 percent, the cost of giving for a donor now in the 40 percent bracket is raised from $.60 per dollar to $.86 per dollar -- an increase of 43 percent.) The proposals that he studied could have been expected to reduce total giving by individuals anywhere from 10 to 23 percent and giving to higher education somewhere between 28 and 42 percent. Again, the impact on higher education is even greater than the impact on charitable giving generally because of the disproportionate dependence of higher education on donors who are more sensitive to the net cost of giving.

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*The technical measure of this effect used by economists is price elasticity. A recent review of the results of many studies (by Professor Charles Clotfelter of Duke University) concludes that the range of most likely values for this elasticity is -0.9 to -1.4. A value of -1.0 implies that, as the text indicates, a 10% rise in the net cost of giving (the "price") should be expected to lead to an equivalent 10% drop in giving.

Needless to say, these factual and empirical propositions do not dictate any one approach to taxation, and I know of no one in higher education who believes that a final judgment about the overall desirability of a flat rate tax (or a value-added tax, or any other major kind of tax) should be governed by the effects I am discussing.

Thus, I wish to emphasize, Mr. Chairman, that my purpose in testifying today is not to advocate or oppose any particular plan for tax reform. It is undoubtedly true that a flat-rate tax, for example, would have many important benefits. Reductions in marginal tax rates, which all flat-tax proposals imply, could stimulate labor supply and savings and generally make the economy more efficient. There could also be other advantages: the tax system would be simpler, the rate of compliance might be higher, and greater "equity" (as many of us would define that elusive concept) might be achieved.

At the same time, the major "side-effects" of such proposals on charitable giving -- and particularly on giving to higher education -- need to be recognized explicitly. They need to be taken into account in devising particular tax proposals, and, equally important, in thinking creatively about additional ways in which the right kinds of incentives can be maintained.

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Perhaps I serve the Committee best by indicating why I believe that your success in addressing these questions matters so very much. It is no exaggeration to say that both the quality and the character of American higher education depend on our sustaining a healthy flow of private funds.

The American system of higher education is unique in the world. It has proved itelf to be an astonishingly effective instrument for the accomplishment of national goals ranging from the education of leaders for every vocation, to the specialized training of highly qualified professionals, to the development of a research base unmatched in the world, to the opening up of opportunities for young people from all backgrounds. It has been able to serve these goals so well because it has been able to utilize a combination of private and public resources -- and because it has had the constant stimulation and rejuvenation that come from individual initiative and institutional diversity.

On campus after campus, distinctive features of the educational landscape, as well as programs of particular excellence, owe their existence to individual donors of vision as well as generosity. In this country, private and public support have been powerfully complementary in what they have allowed us to achieve. In short, our system of higher education has not been monolithic.

As we look outside the United States, at other systems of higher education, it is easy to see what happens when the state is driven to assume essentially full responsibility for educational finance and thus for program. In my view it would be a tragedy -- nothing less than that -- if the erosion of incentives for private contributions were to move us in that direction. That is, I submit, what we must avoid.

Preserving quality and variety -- through encouraging multiple donors, both private and public -- is important in and of itself. But there is also a spirit to be retained, a philosophical approach if you will, which has long distinguished this society and which I think all of us would hate to see lost.

John Gardner, who has thought more about these questions than almost anyone else, from both inside and outside government, has written:

> "The tax deductibility of charitable gifts is a long-established policy designed to further an authentically American idea -- that it is a positively good and important thing in American life for a great many people, quite independently, in their capacity as private citizens, to contribute to charitable, religious, scientific, and educational activities of their choice. And we have demonstrated that preserving a role for the private citizen in these matters encourages creativity, and keeps alive in individual citizens the sense of personal caring and concern so essential if a mass society is to retain the element of humaneness."

A personal illustration of the continuing difference in approach between this country and other countries was provided by a former colleague of mine at Princeton, Frederic Fox, who told me of an exchange that took place when he was visiting Moscow University as part of the celebration of his class's 30th Reunion. A Soviet scientist was asked if the graduates of the University of Moscow ever give money to the University. He was astonished by the question and replied, "No, there is no need for such gifts ... It would be like giving money to the post office."

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For these and other reasons, those of us in the colleges and universities hope that the Congress will want to continue to encourage contributions of private dollars for programs of education and research that serve what are plainly public ends. More specifically, we urge:

1. That in any program of tax revision, the charitable deduction be retained;

2. That this deduction be applicable to the highest marginal tax rate, not simply to a lower base rate; and

3. That any reductions in the incentive to give, resulting from decreases in marginal rates or other actions, be offset by alternative mechanisms that will serve to stimulate private support of teaching and research.

The members of this Committee, more than any other group in the Senate, realize that even small changes in the tax code can have enormous unanticipated effects. Major changes have the possibility of reordering the entire structure of society. As the debate over tax policy evolves, we hope that you will permit us to stay in close touch with you. We are now in the process of refining and bringing up to date the research which has been so useful in assessing the effectiveness and the efficiency of the charitable deduction. We will want to make the results of that work available to the Committee, as well as further ideas that we may develop concerning new mechanisms for the support of charitable purposes.

Your willingness to hear our views today, Mr. Chairman, gives us hope that in the necessary work of reevaluating our system of taxation, damage that no one would cause intentionally will not be caused by inadvertence. Thank you very much.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. I think this panel has indicated that there are two ways that Congress could provide disincentives to a lot of things, whether it is charitable contributions or buying mortgage revenue bonds or investing in various IRA's or other savings incentive programs. And the two things are, first of all, the wipe out the deduction, or the credit, or the tax preference that benefits that particular group. And the other is to reduce taxes. And I think Mr. O'Connell and President Bowen have both made that latter point very clear. A tax reduction itself is something which affects your interests, and I guess, really, the question we have to face is, well, given the fact that that is a side effect—and a bad side effect—are we going to go ahead anyhow? Because it is my view that the present situation is totally ridiculous, and it is further my view that the Chinese water torture that we were engaged in, both in 1982 and 1984, where we tried to make long lists of particular loopholes and all the lobbyists flocking in here trying to protect their loophole was a torture that we don't want to—at least I don't want to—go through again. And I understand what each of you is saying, and I feel for you but I can't quite reach you.

Mr. O'CONNELL. May I respond?

Senator DANFORTH. Sure.

Mr. O'CONNELL. I was struck—thunderstruck—by something that Emil Sunley said about how he now perceives things differently now that he is out of the Treasury. We tangled a lot with Mr. Sunley when he was in the Treasury because we found him so narrowly focused on tax policy. It was amazing to hear him sit here and say that he wishes now they had looked in terms of public and governmental policy and not strictly tax policy. I would submit, Senator Danforth, with all the sympathy for what you have been through and probably will go through again, that that is your job, and that you have to have the capacity to say no to them and maybe to me. All we are asking is that you take a look at what is good public policy—what is good for the country before you to narrowly focus on the tax policy alone.

If you take a look at charitable contributions, for example, I am quite sure that you, in terms of your background and interest, will recognize what these have meant to the kind of country—the kind of people—we are.

Mr. BOWEN. May I respond to Senator Danforth's understandable, heartfelt plea? I think that no one who is concerned about the effects on charitable contributions of the proposals that we are discussing would regard that as a consideration so powerful as to argue against major changes in the Tax Code, should such changes seem desirable on other grounds. Certainly, that is not what I am saying. But I think there are things that can be done, while seeking some of these larger objectives, that will prevent the side effects from being too disastrous. Clearly, retaining the charitable deduction in whatever system emerges is important. I think the way the deduction is geared to the marginal rate is important. I think too that there may also be alternative mechanisms that one can imagine for stimulating private support of, for example, education and research that would offset some of the inevitably decreased incentives that will follow from trying to serve what are larger purposes of public policy.

So, if I may say so, I don't think it is impossible to reach us. But I think the reaching—reaching each other really—is going to require a considerable effort and some new thinking.

The CHAIRMAN. I tend to share the agony. In fact, we have shared the agony in this committee of trying to put together tax proposals, but I think we do have some obligation to continue that process to broaden the base, and I have said many times publicly that I hear a lot of charges about the President being unfair, and I can't recall in my years in the Congress any administration that sent forth more loophole closers than they have in the past 3 years around here. And it has been very painful for us, and most of those have been retained. We lost withholding, which was the bankers who won that one. And maybe they were correct. I am not going to get into that again because I just got my toaster back. [Laughter]

You have those problems from time to time. Now, the realtors want to continue their mortgage interest exemption—right?

Mr. CARLSON. Yes, sir.

The CHAIRMAN. If you have one house or five houses, you want to keep it all. Is that it?

Mr. CARLSON. Let me talk about the generic problem.

The CHAIRMAN. Talk about our problem. You know what your problem is, but——

Mr. CARLSON. Your problem is that you have too little savings to go in the future, and when it turns out that a person stretches himself to get into a home, he develops a discipline to save for the payment on the home initially. When the income goes up and it is less of a burden, they transfer that savings over to the business sector so you have a net increase in savings. People in the same income level who own their own homes save 50 percent more than those who don't. So, in terms of economic growth and savings, it is a discipline in our society that should be fostered.

The CHAIRMAN. Would you put any limit on it at all? I am talking about the second home or third home. Or do you just think that that is something that we shouldn't touch at all. I am just asking the hard question. I mean, we can already see the line starting to form of people who don't want us to change anything, and I wonder how long it is going to be.

Mr. CARLSON. I think the lifestyles are changing considerably, and what you would think would be a luxury second home is turning out to be a seoond home that is associated with one's business activities or lifestyle choices. So, I think that is a risk to go ahead and make the cut that way.

The CHAIRMAN. I am not suggesting that be done, but I am just trying to find out if there is some common ground her because I notice you state in your statement that Congress and the President have been antisavings and anti-investment. Does your statement refer to lowering the rates, adopting indexing, and improving IRAs, and adopting a substantially shorter writeoff period for real estate? Before 1981, what was the typical depreciation period for commercial real estate?

Mr. CARLSON. On the component depreciation, it was around 20 to 22.

The CHAIRMAN. What about residential real estate?

Mr. CARLSON. Residential has never been subject to depreciation, unless it is rented.

The CHAIRMAN. What about rental?

Mr. CARLSON. Rental properties on the component depreciation, you had people in the 20 to 22 years effectively through component depreciation. Others did not use that technique and had a longer period of time. The point I am referring to, Senator Dole, is in table 1 and table 2, where you see the national savings rate and the net domestic investment rate. It is less than half in the 1980's compared to the 1950's, 1960's, and 1970's.

The CHAIRMAN. We had a recession in there, too.

Mr. CARLSON. Yes, we do, but if you look on table 2, that is the forecast, and you are not going to get up to the comparable rates in the other decades in the future either, or at the present time. Right now, we are discouraging, relative to our history, savings and investment. And the home ownership rate has gone down, too.

The CHAIRMAN. I guess my question is can we go back and undo all those things we did in 1981? If you think it is an anti-investment, why don't we go back and repeal all those——

Mr. CARLSON. As you know, we felt that the reversal track that you took this year—going up to 18 years from 15 years—was a mistake for rental housing.

The CHAIRMAN. But if in fact we have been hand-tying investment and antisavings, then we ought to go back and take a look at those and go back where we were. I mean, if you were better off before, are you suggesting we go back to where we were in 1981?

Mr. CARLSON. I am suggesting that the rate you have now at half of what it was in history is not the place to be. You need more encouragement for savings and investment.

The CHAIRMAN. I don't disagree with that but I am wondering how we would do it.

Mr. CARLSON. We would be glad to give you some specific suggestions.

The CHAIRMAN. More subsidies? More tax goodies?

Mr. CARLSON. You call them subsidies. I would say that we ought to have in the Tax Code encouragement of adequate savings and investment for both physical and human capital. We are running into a labor-short economy and we are going to need both in the future.

The CHAIRMAN. But on the other hand, we have interest rates that aren't going down. Do you expect them to come down based on the recent stock market rally?

Mr. CARLSON. No, I would expect the inflation rate to slowly be moving up, so the real interest rate would be coming down somewhat, but rather slowly. I would expect real interest rate—the interest rate above the inflation rate to be double what we have seen in the postwar period, because of the size of the deficit that is really creating fear of crowding out private sector from Government taking the scarce savings in the future.

The CHAIRMAN. But you are not suggesting any increase in personal income taxes?

Mr. CARLSON. No, I wouldn't phrase it that way. I do think that the device that we are using for indexing is defective, and there ought to be a dampening of its full effect—CPI minus one or something like that. And the same comparable thing on the spending side.

The CHAIRMAN. On entitlements?

Mr. CARLSON. Yes.

The CHAIRMAN. Right. That is the position the realtors had this year.

Mr. CARLSON. Yes.

The CHAIRMAN. And as I said, I think at the time, I think that idea may—just looking at the different—the broad bipartisan support of fairly broad that it had—maybe something would be in the mix next year, but I think we have to keep the pressure on the spending side before we start looking at the revenue side.

Mr. CARLSON. Yes.

The CHAIRMAN. That is my only comment in that area.

But then we move to the interest paid on State and local obligations. How do you treat those? General obligations, of course, are constitutionally exempt but——

Senator BRADLEY. They would be fully excludable. There is a mistake in Mr. O'Brien's testimony. He maintains that they would only be excludable at the 14-percent rate. That is not true. Under the FAIR tax, they are fully excludable, whatever the marginal rate of the taxpayer. That was an error in his testimony.

Mr. O'BRIEN. I'm sorry. I didn't hear you, Senator Bradley.

The CHAIRMAN. That you made a mistake.

Senator BRADLEY. You made a mistake in your testimony.

The CHAIRMAN. You indicate that your primary argument is that States and localities need to borrow cheaper because they cannot further increase taxes or use their fees. I wonder if they ever thought about cutting spending at the State level? Maybe they could do that.

Mr. O'BRIEN. I don't want to speak for the municipal finance officers, but I think that that is something they are looking at. Certainly out in California, you have the new legislation proposed that is before the ballot. They are going to have to cut spending, and I think it is in the process now. We do have a rather old infrastructure around the country that has to be rebuilt and maintained, and that is going to have to be financed. And it has got to be paid by taxpayers, and we are all taxpayers, on the Federal level and the local level, and it is just a function of how deeply do you want to bite into that tax—that ability—that revenue stream.

The CHAIRMAN. Your bill doesn't cover IRB's and mortgage revenue bonds, does it?

Senator BRADLEY. Yes.

The CHAIRMAN. That would be taxable. Do you agree with that—that that is a good idea?

Mr. O'BRIEN. I think that there are some abuses in every tax package that comes out. There are certain rights for localities to build housing in certain areas which would be lower income areas and things like that.

The CHAIRMAN. I just noticed—in New York City—I listened to Governor Cuomo make that impassioned speech about fairness at the convention. We learned yesterday that he is going to give $180 million in mortgage revenue bonds on a first-come, first-served basis. You could be millionaires if you are lined up in the right line. And we have checked with some of the banks, and there is no effort to help low-income people. So, I wonder where all this fairness comes from. I have written to Governor Cuomo suggesting that, based on his rhetoric in San Francisco, I expected more. But, to me, that is a policy decision we tried to make here. Senator Packwood addressed it earlier. If we are going to use the Tax Code, we ought to use it to help people who can't do something themselves. But then when a Governor from the second largest State says line up, first come, first served, with no reference to your income, to me that means we have got to do something else to the Tax Code. Maybe we have to make certain that doesn't happen again. But I would hope the Governor would rearrange his priorities and adopt some fairness in that area. Do you have a question?

Senator BRADLEY. Yes. Thank you very much, Mr. Chairman. I would like to welcome Dr. Bowen to the committee. I am sorry I wasn't here when he made his statement and I would like, if I could, to pursue his testimony a little bit and try to raise just a few points. In the testimony as I have read it, you give great weight to the work done by the economist, Charles Clotfelter. And based on a recent study that he did for Brookings on the price and income elasticities of giving, you seem to give more weight to his work than he himself does in that he says in that study that caution should be used in making policy prescriptions on the basis of these findings. And so, I wondered if you conclude that lowering tax rates will case a decline in giving, why, in the period when we dropped the rate from 70 percent to 50 percent, did charitable contributions to education institutions rise by 6.2 percent?

Mr. BOWEN. Let me respond to both the implicit question about the reliability of the findings and the specific question about experience with the 1981 changes. By fortunate coincidence, I received just 2 days ago a summary by the National Bureau of Economic Research of a new publication that is to come out under the imprint of the University of Chicago Press, which has a paragraph by Professor Clotfelter on this specific issue. It is brief. Let me just read it because I think it is directly relevant.

> Taken as a whole, the empirical work on tax effects and individual giving is notable for the number and variety of studies in the area and the consistency of the findings. In few other applied areas in public finance has there been such extensive replication of empirical findings using different data sets. Studies of charitable contributions have used aggregated and individual data, data from tax returns and survey data in foreign as well as U.S. experience. The consensus of these studies is that the price elasiticity for the population of taxpayers is probably greater than one in actual value.

And then he goes on.

I don't think that he and I have a different view of the reliability of the data. Obviously, there is a range, but there are few empirical regularities that I know of that that are more soundly grounded in existing research than this one.

Now, as for the 1981 change, there were of course, as you know so much better than I, many aspects of the Tax Code that were changed simultaneously, and so it is hard to sort out the separate effects. The fact that giving in the aggregate has gone up does not mean that there has been no negative effect. In addition to needing to correct for inflation and for other things that have occurred in the economy, you have to compare what has happened with what you have reason to expect would have happened in the absence of the change. Preliminary results that I have seen suggest that there was indeed a significant effect, particularly among certain categories of donors. Finally, if I could make a third response. My own concern in this area is not just with the immediate or short-term effects. Indeed, it is really much greater for the long-term effects that will occur well after our times. What I fear is that the habit of giving, if you will, the notion that this is a good and useful and proper way to serve the national interest, will be eroded overtime—that what will be lost is not just the gift that was stimulated in its amount by the Tax Code, but the example of that gift for others. It is the cumulative effect over some long period that I think is grounds for the most serious concern. And that is why in my testimony I put so much weight on foreign experience. If you compare the United States and Great Britain, you see dramatically different systems of higher education. And those differences are not unrelated to tax incentives for private giving and for private donations.

Mr. O'Connell. Senator, could I add just a couple of figures that I think would be relevant there?

Senator Bradley. If you could, I would like to just pursue this line of questioning. In your testimony, you said you think the main reason that people give is altruism, not tax avoidance. Why wouldn't that continue to be true?

Mr. Bowen. I think that it will continue to be true. I am not suggesting that private giving would fall to zero. I don't believe that for a moment. What I think is clear is that the amount people give—the degree to which they are able to be generous—is influenced by the Tax Code. And that is what I think these studies are showing: not that people give because there is a tax break, but that the amount they give is a function of tax provisions. In my own experience, with a great many marvelously generous people, what they are able to do and what they do in fact do is affected by the Tax Code, and that is what I think we are seeing.

Senator Bradley. Mr. Chairman, I'd like to wrap up this very useful discussion by saying that I think we should keep some tax incentive for charitable giving, as the Fair Tax Act does. But I don't think the case has been made that lowering tax rates will cause a precipitous drop in the amount of donations. I'd also like to say that if I could, you know I think there is a real tension here as to whether you want to keep tax rates high to encourage certain things or whether you want to lower them, and I think that the contributions of the witnesses have been very positive. And I appreciate their willingness to come before the committee.

Mr. Bowen. Could I make one last response? As I have said in the written testimony, this presentation testimony is not meant to oppose at all the kinds of, I think, very intelligent revisions of the Tax Code that are being pursued. It is meant simply to suggest that we have to deal with what are, I think, perfectly predictable effects, at the same time that we seek to revise the code.

Mr. O'Connell. Mr. Chairman, may I give just a couple of facts that I think are important to Senator Bradley's point?

The CHAIRMAN. Yes.

Mr. O'CONNELL. You talked about reducing the tax bracket from 70 to 50 percent and yet giving went up 6.2 percent. There are two things that happened in that Tax Act. One, the reduction of the top bracket from 70 to 50 percent. The other was allowing nonitemizers to deduct. Treasury's own figures indicate that for persons with incomes in that upper tax bracket, giving dropped almost 20 percent. The 6.2-percent increase in overall giving was made up by taxpayers with incomes under $30,000. So, in terms of both questions, retaining the itemization of the deduction for those that use the long form and retaining the itemization for those newly allowed to deduct, are both terribly important.

Senator BRADLEY. So, the statement you just made confirms that for big givers, the drop of the top rate from 70 to 50 did reduce the amount of contributions. Right?

Mr. O'CONNELL. Sizably.

Senator BRADLEY. Yes, although the overall contributions were up 6.2 percent because the small contributors gave.

Mr. O'CONNELL. Significantly.

Senator BRADLEY. The idea was to encourage the small givers and that is why we changed in the law in 1981.

The CHAIRMAN. Could I just say that obviously we are in the very early stages. We had 3 days of hearings last year on some of these proposals, and we will have one more hearing this week and more in September. We have talked some about field hearings. But everyone here certainly has an interest that they have a right to protect. I mean, if you see a problem, obviously we are going to hear about it. So, I don't mind people lining up in the hallway. We are just sorry we can't accommodate everybody with a seat, but we are obviously not, as I said at the outset—the purpose of this hearing is not to design any "tax increase this year." The President has made it very clear that—and I understand Senator Bradley has had a press conference while we have been here saying that I want a tax hike and George Bush wants a tax hike—why doesn't the President want a tax hike? Or something. But I haven't said that. I said, in a well written, 600-word piece in the Washington Post on Sunday——

Senator BRADLEY. You want a revenue enhancement. [Laughter.]

The CHAIRMAN. I just said there were some options that we had to look at. [Laughter.]

But I think you understand that there is no way we can do anything between now and November that would be constructive. And there is not much precedent for doing much constructive after November, but we could at least give that a shot. Hopefully all of us would get together right after the election and try to hammer out some way to go next year as far as deficit reduction. But I would think, like Dr. Carlson, your biggest concern has got to be interest rates, and you are telling me that you don't see any change. Is that view shared by Salomon Bros? You want to give us a little free advice while you are down here?

Mr. O'BRIEN. It depends on what the political ramifications of the markets are, sir. [Laughter.]

The CHAIRMAN. But I don't understand all that stuff. [Laughter.]

But if the rates are coming down, it will be good news for a lot of people.

Mr. O'BRIEN. I think we are in store for some tremendous volatility between now and year end. We will have higher rates and lower rates because people don't know what is going to happen, including the investment community.

The CHAIRMAN. Right. Does anybody else have anything else? We know that you have all that in your statements and that they are all made part of the record. What time is the hearing tomorrow—10?

Mr. DEARMENT. Yes. 10.

The CHAIRMAN. I might include in the record my letter to Governor Cuomo, pleading with him for fairness when it comes to issuing mortgage revenue bonds. They should not go to the rich. They should go to people who deserve it. In fact, in the Senate Finance Committee bill we passed, we provided language that there should be a procedure adopted to make certain that it went to—that the benefits were received by people in low income areas. So, I do seriously hope that he will correct that because they have been a model State for that program. We hate to see it go the other way.

Thank you very much.

[Whereupon, at 1:30 p.m., the hearing was recessed, to reconvene on Wednesday, August 8, 1984, at 10 a.m.]

[Senator Dole's letter to Governor Cuomo follows:]

ROBERT J. DOLE, KANS., CHAIRMAN

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United States Senate
COMMITTEE ON FINANCE
WASHINGTON, D.C. 20510

August 6, 1984

The Honcrable Mario M. Cuomo
Governor
State of New York
State Capitol
Albany, New York 12224

Dear Governor Cuomo:

Your recent Keynote Address at the Democratic Convention gave me hope that you would take the lead in encouraging State Governors throughout the United States to ensure that low-interest mortgage loans financed by federally tax-exempt bonds would be targeted to lower income families. I am disappointed that, despite your moving rhetoric about "fairness", the State of New York Mortgage Agency (SONYMA) is on the verge of distributing $179 million of low-interest mortgage loans on a first-come, first-served basis, with no restrictions or guidelines on the incomes of the recipients of this valuable Federal subsidy.

Telephone calls this morning to several of the lending institutions distributing loans in the New York City Metropolitan area revealed that lines are already forming outside the banks to obtain applications that will be available in two days. The lines are understandable, since the mortgages will be given to those first in line to apply, without any determination of need. At a time when serious Federal deficits require the Congress to review carefully the cost-effectiveness of each and every Federal expenditure, it is unfortunate and unfair for the State to use its discretion to distribute a limited amount of Federal housing assistance in this arbitrary manner. Federal housing subsidies should not be given out by State agencies like tickets to the World Series, or the Jacksons' Victory Tour.

This year, both the House of Representatives and the Senate agreed to extend the Federal mortgage subsidy bond program. But the Republican-controlled Senate insisted on adding an explicit statement of Congressional intent that State and local governments are expected to use their mortgage bond authority "to the greatest extent feasible (taking into account prevailing interest rates and conditions in the housing market) to assist lower income families to afford homeownership before assisting higher income families".

The Senate Finance Committee report explained that this policy could be implemented by adopting "procedures to ensure that the availability of ... loans is widely publicized, and that application for such loans are reviewed with respect to family income and assets so that lower income families can be given priority over higher income families in receiving such loans". Our concern was prompted by a General Accounting Office report issued in 1983 finding that purchase price limits imposed by Federal law were ineffective in targeting loans to those most in need of assistance.

The State of New York has, in the past, been a model for other states operating housing assistance programs under the Federal mortgage subsidy bond provisions of the Internal Revenue Code. You personally have exercised leadership in urging that "fairness" be a high priority in implementing governmental programs.

I sincerely hope that as the Chief Executive of the State of New York, a leader among State Governors, and a prominent Democrat, you will exercise leadership to ensure that mortgage subsidy bond programs in New York and throughout the country implement the intent of Congress that lower income families be given priority in receiving program benefits.

Sincerely yours,

BOB DOLE
Chairman

BD:dsm

MAJOR TAX REFORM OPTIONS

THURSDAY, AUGUST 9, 1984

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to recess, at 10:09 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Packwood, Roth, Danforth, Symms, Grassley, Long, and Bradley.

The CHAIRMAN. We are ready to resume our second day of hearings. As I have indicated before, we will have additional hearings in September. I apologize to those who wanted to be heard during this 2-day hearing, but it just wouldn't have been fair to the witnesses to have them come and not have any time to give their statements.

We are pleased to start off today with our colleague and chairman of the Appropriations Committee, who retired this morning I think at 1 a.m. We are very happy to have Senator Hatfield here, to be followed by Senator Dan Quayle, and then we will get into the other witnesses as quick as we can.

Mark, you may proceed in any way you wish. We are happy to have you here.

Bob.

Senator PACKWOOD. No comments, no.

STATEMENT BY HON. MARK O. HATFIELD, U.S. SENATOR FROM THE STATE OF OREGON

Senator HATFIELD. Thank you, Mr. Chairman, and my colleagues. I have about an eight-page statement, but may I submit this for the record and get to the heart of the proposal that I would like to suggest for this committee's consideration?

Mr. Chairman, gentlemen, as you know, a number of creative options have been offered in this Congress, and I am pleased that so many of my colleagues have taken up the cause. In particular, Senators Bradley, Kasten, Quayle, DeConcini, Helms, Mitchell, and Roth deserve special mention.

Since 1972, for about 12 years, I have been advocating and introducing versions of what I call a simpliform tax proposal. A complete discussion of this proposal, S. 2158, appeared in the January 30, 1984, issue of Tax Notes, and I would like to submit that particular article for the record. It goes into detail on this proposal that I have been interested in for a dozen years or so.

Briefly, simpliform taxes individuals at graduated levels from 6 to 30 percent and would do so without shifting the tax burden to low- and middle-income taxpayers and without sharply reducing the taxes paid by the well-to-do.

The distributional impact is neutral across all income levels. These sharply lower rates are made possible by broadening the revenue base to include an array of previously excluded items such as unemployment compensation and interest on municipal obligations. As much as possible, we ought to strive to treat income from a variety of sources in a more equal fashion. In place of the dozens of special deductions, credits, and special tax incentives, only five new tax credits would be created:

No. 1. A $250 credit for each taxpayer, spouse, and dependent.

No. 2. A 20-percent credit for charitable contributions in excess of 1 percent of adjusted gross income.

No. 3. A 15-percent credit for mortgage interest paid in excess of 1 percent of adjusted gross income.

No. 4. A 15-percent credit for State and local taxes paid that exceed 1 percent of adjusted gross income.

No. 5. Last, a 20-percent credit for medical expenses exceeding 10 percent of adjusted gross income.

Now, Mr. Chairman, basically what I am proposing here is not a tax reform. I think the day has passed that we can play with tax reforms. I think we have to abolish the tax structure. I think we have to take a radical step forward in recognizing that we have an unenforceable tax structure today that we lose approximately $100 billion a year because it's not enforceable, and that is due in part at least to the complexity of that tax structure. And this program that I am advocating today is not a tax reform; it's a restructuring of the tax system. And it simplifies it to the point where I believe it would be enforceable.

Utilizing tax credits instead of tax deductions will make the special tax incentives we adopt more equitable to all taxpayers.

For example, 60 percent of all homeowners do not currently use the mortgage interest deduction. A tax credit for mortgage interest would extend the present tax subsidy to virtually all homeowners with mortgages. Moreover, converting the deduction into a credit would in general equalize the rate of subsidy provided to homeowners with mortgage payments.

For example, if two taxpayers have a home mortgage with an interest rate of 14 percent and one is in the 50-percent tax bracket while the other is in the 20-percent tax bracket, our current tax system reduces the interest rate to 7 percent for the former and 11 percent for the latter. In contrast, a 15-percent tax credit would provide a 15-percent reduction for both taxpayers.

The advantages of utilizing a simple and equitable mortgage interest tax credit can be equally applied to the other four credits for charitable contributions, medical expenses, State and local taxes paid, and personal exemptions for a taxpayer, spouse, and dependents.

If enacted, simpliform would revolutionize and in my view energize our tax system with lower rates, greater equity, and increased economic efficiency, without the regressive character of a flat tax. And the advantages, as I see it, are: One, drastically reducing the high marginal tax rates that punish savings and investment at the expense of borrowing and consumption; two, meeting head-on the explosion of tax expenditures that erode the efficiency and the fairness of our tax system; three, retaining a limited tax incentive for five basic provisions—personal exemptions, charitable contributions, mortgage interest, medical expenses, and State and local taxes paid; four, making these five incentives equitable and equally available to taxpayers across all income levels; five, simplifying our tax system by eliminating a host of special exclusions and deductions as well as dozens of special forms that confuse and frustrate millions of taxpayers; six, by restoring confidence in the fairness and simplicity of our Tax Code, we will see new life in our voluntary or self-reporting system of taxation; seven, broadening our tax base in treating income from a variety of sources in a more equal fashion, which is politically difficult but must, I believe, be done; eight, eliminating the marriage penalty and recognizing the important contribution of women to our economic welfare by the utilization of individual income tax filing; and nine, retaining indexing of rate brackets, personal exemptions and capital assets to ensure that inflation does no not undermine the incentive to work, save, and invest.

To the skeptics in this room and this city, tax reform may be a product with no market. But from visits and correspondence with constituents, I believe there is a vast untapped reservoir of support for a complete restructuring of our tax system—a radical approach.

I use the term "radical" advisedly, as Webster describes it, "to go to the root." Because of its virtues of simplicity, fairness, and increased economic efficiencies, simpliform should be a serious contender in the tax policy debates that are sure to come.

I thank the Senator and the committee for permitting me to appear here this morning.

[Senator Hatfield's written statement follows:]

SENATOR MARK O. HATFIELD
SENATE FINANCE COMMITTEE
HEARINGS ON COMPREHENSIVE TAX REFORM

AUGUST 9, 1984

MR. CHAIRMAN:

AT A TIME WHEN WE ARE STRUGGLING TO IMPLEMENT A DEFICIT DOWNPAYMENT PACKAGE, IT IS INDEED APPROPRIATE THAT WE TAKE A CAREFUL LOOK AT WHERE WE ARE GOING WITH OUR TAX SYSTEM. I BELIEVE WE CAN NO LONGER LOOK TO PIECEMEAL EFFORTS WHICH FOCUS ON SQUEEZING INFORMATION OUT OF TAXPAYERS OR ENACTING RIGOROUS PENALTIES ON ERRANT INDIVIDUALS AS A LEGISLATIVE SOLUTION TO OUR INEFFICIENT AND COMPLEX TAX SYSTEM. I COMMEND YOU FOR SCHEDULING THESE HEARINGS, AND I WISH TO ASSOCIATE MYSELF WITH YOUR EFFORTS IN THIS COMMITTEE TO FASHION A MAJOR TAX REFORM PROPOSAL IN 1985.

MR. CHAIRMAN, YOU AND I ARE FINDING OURSELVES IN A GIANT FISCAL PIT WITH FEW VIABLE ESCAPE OPTIONS REMAINING OPEN TO US. IN THE AUGUST 6TH ISSUE OF TAX NOTES, DR. ALLEN MANVEL WRITES THAT UNCONTROLLABLE SPENDING -- I.E., THOSE ITEMS THAT CANNOT BE MATERIALLY AFFECTED BY THE ANNUAL APPROPRIATIONS PROCESS BECAUSE THEY RESULT AUTOMATICALLY FROM PREVIOUS GOVERNMENT COMMITMENTS OR PROVISIONS OF EXISTING LAW -- CONSTITUTED 74.6 PERCENT OF ALL FEDERAL OUTLAYS IN 1983.

THE MAJOR CULPRITS ARE NET INTEREST COSTS, FEDERAL MEDICAL CARE SPENDING, AND EXISTING MILITARY CONTRACTS. WHEN NEW DEFENSE APPROPRIATIONS ARE FACTORED IN, THE FIGURE REACHES 82.5 PERCENT.

OUT OF THE REMAINING 17.5 PERCENT, WE ARE EXPECTED TO FIND THE BUDGET SAVINGS THAT WE SO DESPERATELY NEED. IT TAKES NO ECONOMIC GENIUS TO CONCLUDE THAT DISCRETIONARY DOMESTIC APPROPRIATIONS ARE NEITHER THE CULPRIT OF OUR DEFICIT NOR ARE THEY LIKELY TO GIVE US THE SUBSTANTIAL BUDGET SAVINGS WE NEED.

DESPITE REMARKABLE RESTRAINT OVER DOMESTIC APPROPRIATIONS BILLS OVER THE LAST FOUR YEARS, WE FIND OURSELVES LOSING GROUND TO OUR CONSTANT NEMESIS -- THAT IS, THE UPWARD MARCH OF OUR NATIONAL DEBT. IN THE AUGUST 1984 BUDGET UPDATE OF THE CONGRESSIONAL BUDGET OFFICE, THE CBO PROJECTS OUR DEFICIT TO RISE FROM $172 BILLION IN 1984 TO $263 BILLION BY 1989. TOTAL DEBT IS SCHEDULED TO RISE FROM $1.3 TRILLION IN 1984 TO $2.5 TRILLION IN 1989. INTEREST COSTS ALONE IN THE REVISED CBO FIGURES HAVE INCREASED SOME $50 BILLION OVER 1984-1989. IN SHORT, THAT IS A 93 PERCENT GROWTH RATE. AND IT WILL EAT UP A GOOD CHUNK OF WHAT WE HAVE WORKED SO HARD TO ACHIEVE IN THE 1984 DOWNPAYMENT PACKAGE.

BECAUSE NET PRIVATE SAVING IS ONLY SUFFICIENT TO FINANCE SLIGHTLY MORE THAN ONE-HALF OF GOVERNMENT'S CREDIT DEMANDS, IT IS BECOMING NECESSARY TO LOOK TO NEW SOURCES TO FINANCE OUR NATIONAL DEBT. THAT SOURCE IS FOREIGN INVESTORS, AND THE FIGURES HERE ARE EQUALLY DRAMATIC -- $11 BILLION IN 1982; $41 BILLION IN 1983; AND $80 BILLION IN 1984. IN THE NEXT FIVE YEARS WE WILL SPEND $936 BILLION IN INTEREST PAYMENTS. WHAT CAN WE EXPECT WHEN NET INTEREST COSTS REACH THE $214 BILLION FIGURE IN 1989? FOR YEARS THE NEW DEAL ECONOMISTS TOLD US THAT WE ONLY OWED THE NATIONAL

DEBT TO OURSELVES. BUT THE BURDENS WE ARE IMPOSING TODAY WILL HAVE A LASTING EFFECT ON THE PRIORITIES IN OUR BUDGET AND THE EDUCATION OF YOUNG AMERICANS IN THE GENERATIONS TO COME, AND THE MILLSTONE OF DEBT WE ARE IMPOSING ON THEM WILL SEVERELY HAMPER THEIR OWN ECONOMIC FUTURE.

WHEN PRESIDENT ROOSEVELT AND THE CONGRESS SURVEYED THE DREADFUL CONDITIONS THEY FACED IN 1933, THEY HAD LITTLE IN THEIR COLLECTIVE HISTORICAL EXPERIENCES TO RELY UPON IN FASHIONING AN APPROPRIATE GOVERNMENTAL RESPONSE. TODAY, OUR STAGGERING NATIONAL DEBT AND EXPLODING INTEREST COSTS PRESENT US WITH A NEW AND UNPRECEDENTED SET OF CIRCUMSTANCES. BECAUSE THE TIME IS SHORT AND CONSEQUENCES SO IMPORTANT THAT THEY TRANSCEND THE ELECTORAL POLITICS OF 1984, I BELIEVE THE DIALOGUE SHOULD FOCUS ON A WIDE VARIETY OF BOLD INITIATIVES. THESE DISCUSSIONS COULD FOCUS UPON:

1. COMPLIANCE WITH THE $139.8 BILLION CEILING FOR NON-DEFENSE DISCRETIONARY PROGRAMS IN 1985 APPROPRIATIONS BILLS AND WITH THE SENATE TARGETS FOR 1986 AND 1987 FOR A SAVINGS OF $17 BILLION.

2. ADOPT DEFENSE FIGURES FOR 1985-1987 THAT BASICALLY FOLLOW THE HOUSE FIGURES WHICH WOULD LOWER OUR DEFICIT BY $52 BILLION OVER THREE YEARS.

3. POSTPONE TAX INDEXING SCHEDULED FOR 1985 UNTIL 1986.

4. PREPARING FOR COMPREHENSIVE TAX SIMPLIFICATION LEGISLATION IN EARLY 1985 THAT WOULD SHARPLY LOWER TAX RATES AND ELIMINATE OR REDUCE THE PLETHORA OF SPECIAL TAX BREAKS THAT COMPLICATE OUR SYSTEM AND SOW DISCORD AMONG A FRUSTRATED CITIZENRY.

THESE SUGGESTIONS MAY SEEM REVOLUTIONARY, EVEN FOOLHARDY, FOR ONE SEEKING RE-ELECTION IN AN ECONOMICALLY DEPRESSED STATE. BUT I BELIEVE THE AMERICAN PEOPLE WANT STRONG BIPARTISAN LEADERSHIP FROM THEIR CONGRESS, AND THEY DO NOT APPRECIATE THE POLITICAL GAMES THAT ARE TOO OFTEN PLAYED WITH THE FEDERAL BUDGET.

MR. CHAIRMAN, I RECOGNIZE THAT I HAVE INTRODUCED THE BROADER FISCAL ELEMENTS INTO THIS DISCUSSION OF TAX REFORM PROPOSALS. BUT IT IS ESSENTIAL THAT WE RECOGNIZE THAT STRUCTURAL TAX REFORM IS INEXORABLY INTERRELATED WITH OUR OVERALL FISCAL DILEMMA. IN MY VIEW, STRUCTURAL TAX REFORM IS A VITAL COMPONENT OF ANY SERIOUS DEFICIT-REDUCTION EFFORT, AND IT SHOULD BE THE FIRST ORDER OF BUSINESS WHEN THE CONGRESS CONVENES IN JANUARY OF 1985.

AS YOU KNOW, A NUMBER OF CREATIVE OPTIONS HAVE BEEN OFFERED IN THIS CONGRESS, AND I AM PLEASED THAT SO MANY OF MY COLLEAGUES HAVE TAKEN UP THE CAUSE. IN PARTICULAR, SENATORS BRADLEY, KASTEN, QUAYLE, DECONCINI, HELMS, MITCHELL, AND ROTH DESERVE SPECIAL MENTION. SINCE 1972, I HAVE BEEN ADVOCATING AND INTRODUCING VERSIONS OF MY SIMPLIFORM TAX PROPOSAL. A COMPLETE

The CHAIRMAN. Well, thank you very much, Senator Hatfield. As we have indicated, we obviously are not going to take any action this year; we are trying to set the stage for what we hope will be a major assault on the complexities in the system.

You are probably right—there may not be much demand for reform, but we are looking around ways to simplify at least what many people consider to be a rather burdensome task, and that's complying with the tax laws.

I have no questions. We are very pleased to have you here.

Senator HATFIELD. Thank you.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. I can only say I know that Senator Hatfield has not come to this new. When he was Governor of the State of Oregon and I was in the State legislature, Mark was an advocate—if we were going to have any tax—of a gross income tax, which is a form of tax simplification. So this is not a bandwagon that he has hopped on in the last year or two as has become very faddish, to advocate a variety of tax reform proposals.

Senator HATFIELD. Thank you.

The CHAIRMAN. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman, and thank you, Chairman Hatfield. I appreciate your interest in this. Do I understand you have a bill that is going to be introduced? Or is it introduced?

Senator HATFIELD. It has been introduced each year, and I have a full copy of it. I submitted also the brief on the bill itself from the article in this tax publication.

Senator SYMMS. Thank you very much. I appreciate your being here.

The CHAIRMAN. Chuck.

Senator GRASSLEY. Senator Hatfield, I have no questions, I just want to thank you for your leadership in this area.

Senator HATFIELD. Thank you very much, gentlemen.

The CHAIRMAN. Good luck in the appropriations, and try to get us out by evening. [Laughter.]

We are now pleased to have Senator Quayle, who has a little different approach. I have talked to Senator Quayle a number of times; it is a little different from the FAIR tax and the FAST tax, and the flat tax. What is this one called?

Senator QUAYLE. This one, Mr. Chairman, is called the SELF tax.

STATEMENT BY HON. DAN QUAYLE, U.S. SENATOR FROM THE STATE OF INDIANA

Senator QUAYLE. Thank you, Mr. Chairman.

As you recall, I had the opportunity to testify before this committee 2 years ago, when you first addressed of tax simplification. I certainly want to applaud your efforts to deal with an issue that is obviously on a lot of people's minds.

I first introduced my self tax bill back in 1981. Since then a number of new proposals have come forth. I think this is generally healthy and demonstrates that interest in this issue certainly has grown.

Before I address some specific points, I would like to make a couple of general observations.

One, tax deductions and tax credits are sort of like Government programs: They are all worthwhile; they were put there for good, social and economic reasons, and they are darned, darned difficult to eliminate. We all say, we want to cut down Government spending," but when it comes down to which Government program gets cut there is always a particular constituency, that will pressure Congress to retain that Government program.

These same institutional roadblocks have crept into the tax credits and tax deduction system as well. Since we proposed the income tax system in 1913, and even more recently in the last couple of decades, the complexity of the Tax Code has become overwhelming.

I think what we are going to have to do—as we have done and attempted to do with the spending programs, in the 1981 reconciliation bill—is to take a broad and, to use Mark Hatfield's word, a radical, approach that is going to be packaged in one nice vote. Because, if we start piecemealing this thing out, there are going to be all sorts of reasons why we can't eliminate this deduction or that credit, and I think we are going to get ourselves back into the system that we have right now.

But I think there is a strong political constituency outside this city for serious tax reform and tax simplification.

I have talked about this in my home State for the last 4 years, and believe me, wherever the crowds may be, in the factories or in the coffee shops or at rallies, there is strong support for tax simplification.

Now, when you get down to the nitty gritty of how to simplify the code, it becomes quite difficult; but I think the principles in our SELF tax are probably not unlike the principles that are in other proposals that have come forth: We want to see simplicity and efficiency. If we have a system that is more comprehendable and understandable, obviously it is going to be efficient. We must see also lower marginal tax rates rather than higher tax rates. That is the direction in which the 1981 Tax Equity Act took us. That act actually increased the share of taxes paid by the rich. I think it is a direction the Congress and the Nation are prepared to go again.

Finally, there is the fairness issue. There is a built-in perception, if not in fact reality, that there is unfairness in the system.

I would like to highlight a couple of points on this complexity issue. This is the primary problem with which we are really grappling. It is an issue, on which you have taken the lead. I remember a number of articles that you have written, stressing the need for simplicity.

As you know, our last tax bill, that noncontroversial nickle-dime tax bill that would raise just a few billion dollars—I admit I didn't read it—but someone said it was something like 1,300 pages long.

Only 1,300 pages on a nontechnical, small tax proposal, which I think illustrates a very, very fundamental point. The only way you are going to deal with this complexity is to have radical surgery and enact quite a fundamental change.

Sixty percent of those people that itemize their tax forms require whether they like it or not, professional help. Although I am not a member of your esteemed committee, I consider myself somewhat versed in tax law. In law school I majored in tax law—though I have not followed it as closely in the last few years—and my wife is also an attorney who majored in tax law in school, and you know, when we sit down on April 14 to fill out our tax returns, and they are not that complicated—I have a fairly straightforward tax return that I file—it is not a very pleasant moment around the Quayle household. And if we have trouble on a very simple tax return, you know where the rest of the American public is.

As a matter of fact, there have been some studies showing that even professional make is a high percentage of mistakes and errors in filing the tax returns with IRS.

We have always prided ourselves on our voluntary tax system. By golly, we voluntarily pay our taxes. But this voluntary system is in danger. If we are going to continue to make it work, to end the growth of the so-called underground economy, we are going to have to make a very drastic move toward simplification.

Our proposal is very favorable compared to some of the other proposals—especially toward the working poor. We have a zero bracket that would go up to $14,000 for a couple with two dependents. For the individual working poor, we have a zero tax bracket of $6,000. And the Joint Tax Committee has analyzed our Self-Tax. As a matter of fact, as of today, our tax is the only reform proposal of which the Joint Committee on Taxation has publicly released in an analysis of the winners and losers. It has concluded that there would be an even number of winners and losers under SELF.

I ask again consent that my entire statement be inserted in the record. Thank you for your continued effort in this area of tax simplification reform. I am with you, and I am at your service.

The CHAIRMAN. Thank you very much, Senator Quayle. We do appreciate your coming before the committee again.

[Senator Quayle's written testimony follows:]

TESTIMONY OF

DAN QUAYLE
U.S. SENATOR

Mr. Chairman, members of the Finance Committee, I appreciate this opportunity to testify here today on the SELF-tax simplification plan. I commend the Chairman and other members for their interest in a topic which is moving inexorably to the top of the National agenda.

Each day increases the probability that Congress will consider major changes in our tax code this winter. Since the President put out a call for "an historic reform for fairness, simplicity, and incentives for growth, in his State of the Union Address last January dozens of reform proposals have sprouted on Capitol Hill. I a proud that I introduced on the Senate floor more than two years ago a proposal which I believe best meets the President's rigorous criteria. In September 1982 I testified before this committee that the SELF tax, now before Congress as S. 1040, stresses what I believe should be the guiding principles of any tax code: Simplicity, Efficiency, Low rates and Fairness. In the two years hence my concern with the tax system has only increased. I believe that only one proposal, however, my SELF tax plan, meets all the President's rigorous criteria best. SELF stresses what I believe should be the guiding principles of any tax code; Simplicity, Efficiency, Low rates, and Fairness.

Our current tax code is a helter-skelter maze that confuses and discourages the average taxpayer. The IRS publishes over 290 forms and schedules and over eight volumes on the income tax alone. In a country where the average taxpayer reads at the ninth grade level, our tax forms assume a college level reading ablity. A GAO study found that merely attempting to file a tax return (to say nothing of correctly completing one) was beyond the ability of over one million taxpayers. In 1954 18 percent of American taxpayers used professional preparers, 50 percent of the population today waste valuable national resources seeking professional help on their tax returns and a 1971 survey showed that even commercial tax preparation firms miscalculate tax payments on 82 percent of low-income returns with itemized deductions. The IRS estimated that the system's complexity and burden encourage errors and tax avoidance that costs the Treasury over $95 billion per year.

The typical taxpayer finds it difficult to understand and even more difficult to accept how his neighbor across the street, who makes the same income he does, can get away with paying thousands of dollars less in taxes. Our tax code is so inequitable, so lengthy and so complex because over the years it has catered to and incorporated into its body, hundreds of special interest windfalls. We have spent the last three years trying to simplify and tinker with the tax code to eliminate some of these unproductive loopholes. By the time we finished our last such effort we had produced an foreboding ~~2000~~ 1300 page volume that opened up as many loopholes as it closed. The only way to make the system fairer and simpler is to overcome the pressure from the iron triangle of special interest beneficiaries, bureaucrats, and ourselves; and totally reform and streamline our present system. By doing so we can broaden our tax base, lower our rates, and let all American taxpayers enjoy the benefits of favorable taxation now open to only a privileged few.

As we consider tax reform this winter we should discard out-of-hand any shortsighted efforts to increase revenues via income tax increases. There is clearly no progress to be gained via this route. Consider, for example, that if the federal government taxed 100 percent -- which is to say confiscated -- all personal income over $75,000 it could reduce the deficit by no more than $33 billion. Of course, this unreasonably assumes that such individuals would continue to earn over $75,000.

Rather, we should look forward to tax reform tht settles for revenue neutrality in the short-term, but is judged by standards of efficiency and equity. The current tax structure is a major impediment to American productivity and economic growth. High marginal rates discourage labor, induce individuals to consume rather than to save, and encourage the manipulation of resources into shelters and commodities rather than productive capital and financial assets. Strengthening the economic expansion requires that the Federal government develop policies which consciously foster work, savings, and investment.

Through low tax rates, generous exemptions to the working poor, and the elimination of hundreds of unnecessary and counterproductive deductions and credits, SELF achieves levels of efficiency and equity unique among the many proposals before the Finance Committee.

In this period of fiscal restraint, any tax reform must meet adequately the primary objective of any tax system: to raise revenues. The Joint Committee on Taxation has analyzed SELF and concluded that in the tax year 1984, it would be virtually revenue neutral -- yielding only 1.2 percent less than the $455 billion collected under current law. I can't imagine we could carry out such major reform with greater neutrality.

Mr. Chairman, we both know that no matter how efficient or revenue neutral tax reform may promise to be, it can never come to be if it upsets the political balance incorporated in our current system. On this count, the SELF tax is the only reform proposal for which the JCT has publicly released an analysis of the winners and losers. The committee concluded that there would be an even number of winners and losers under SELF. More importantly, SELF would leave virtually undisturbed the present distribution of tax liability by income class. Those taxpayers in the $10,000 to $20,000 range would be most affected, but in the aggregate their tax burden would be reduced by only 7.6 percent. This minimal change in distribution is in marked contrast to most flat income tax rate proposals.

In today's political environment another primary criteria of tax policy is fairness to the poor. On this count also, SELF is unequivocably superior to most of its counterparts.

For example, under SELF, individuals with incomes under $7,000 would have absolutely no income tax liability. Contrast this with the current law limit of $3300, or with a current proposal under which the poor individual is taxed on every dollar earned over $4,000. Likewise, a poor couple with two children may earn $14,000 tax free under SELF, but only $11,200 under the same alternative.

SELF also exhibits more compassion than another leading tax reform proposal. Under that proposal a poor individual pays taxes on income over $6,000 at a rate of 20 percent. As I noted above, the same individual can earn an extra thousand dollars tax free under SELF and is then taxed at only 15 percent.

As our current tax system poignantly illustrates, a system cannot remain fair and equitable long if it is not efficient. SELF does not sacrifice efficiency to fairness. Instead of 14 different rates SELF has only four: 0, 15, 24, and 30 percent. Instead of hundreds of deductions and credits SELF retains but a handful. And the most important element of SELF is the reduction of the top marginal rate from 50 to 30 percent. Lower marginal tax rates have vital, far reaching economic benefits for all income classes. Low marginal tax rates encourage individual entrepreneurism and allow individuals to make decisions on work, savings, and investments without regard to punitive and distorting tax rates. Lower rates encourage individuals to substitute work for leisure, increase compliance at the expense of the underground economy, and encourage investors to save for the future rather than consume for the future. Finally, it is perhaps the most effective way in which to reduce the economic and social burden of tax shelters. Low rates simply take the fun and profit out of unproductive loopholes and put them back into productive financial assets.

SELF does even more to encourage productive saving by indexing to inflation all capital gains. This important step is consistent with the overall tax indexing and will boster capital investment in this country.

SELF attains simplicity and a wider tax base largely through the elimination of hundreds of unnecessary and counter productive tax loopholes and deductions. A small handful of deductions; home mortgage interest, IRA's and Keoughs, charities, medical expenses and the like; do promote economic growth, fairness, and traditional American values. However, accordingly, SELF retains these deductions at their full value.

Mr. Chairman, on June 12, I entered into the Congressional Record this modified version of S. 1040. I ask that it be included for the record as part of my testimony here today.

The CHAIRMAN. You know, we are a long way from any consensus on this committee, I think it is fair to say. There are a number of good ideas floating around, but I'm not certain how many votes there are for any of these good ideas. And I have learned that without the votes the idea could be very good but not go anywhere.

We appreciate your leadership. You have indicated to me that there are substantial differences—you have just pointed out a couple of them—between your bill and the other so-called FAIR or flat tax proposals. And we will be looking at all of these differences as we try to reach some consensus.

Senator Packwood.

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Symms.

Senator SYMMS. Thank you very much, Senator, for being here. I just have one question: Did you say—maybe I missed it in your testimony—that your plan is revenue neutral?

Senator QUAYLE. It is.

Senator SYMMS. So it would raise approximately the same amount of revenue to the Federal Treasury as the present Tax Code?

Senator QUAYLE. Yes.

Senator SYMMS. All right; thank you very much. It sounds very interesting and very positive.

The CHAIRMAN. Senator Long.

Senator LONG. Thank you, Mr. Chairman. No questions.

The CHAIRMAN. Thank you very much, Senator Quayle.

Senator QUAYLE. Thank you.

The CHAIRMAN. We now have a panel of four witnesses: Harry Jacobs, chairman of the board, Prudential-Bache Securities; John M. Albertine, president of the American Business Conference and cochairman of the Coalition To Reduce High Effective Tax Rates; Peter D. Herder, president of the National Association of Home Builders; Scott Slesinger, executive vice president of the National Apartment Association.

Harry, I guess we can start with you.

What we have suggested, and I think the witnesses have been notified, is to summarize and just highlight what you intend to point out in your full statement. It would give us an opportunity to ask some questions and still give every witness—and there are 16 witnesses we would like to hear from before noon—the same opportunities. So if we can do that, it would be very helpful.

I would say at this point that all of the statements will be made a part of the record as though given in full for this panel and the subsequent panels.

Mr. Jacobs, we are pleased to hear you at this time.

STATEMENT BY HARRY A. JACOBS, JR., CHAIRMAN OF THE BOARD, PRUDENTIAL BACHE SECURITIES, INC., NEW YORK, NY

Mr. JACOBS. Good morning, sir.

I started flying airplanes when I was a student, and then I was a World War II instructor, and I've been flying ever since. Three years ago for my birthday I rented a restored B-25 in Detroit, and I went up with a group of friends. The piston rings were handmade and the oil went past them, spraying the plugs, and the engine was constantly misfiring and belching black smoke. Needless to say, none of us enjoyed that ride; in fact, my wife almost killed me.

The point I want to make, of course, is that, like that old B-25, our present-day tax system is unworkable. It's patched together and more often than not misfires. It is incumbent on the leadership of the Congress to study and rethink our whole process of collecting tax dollars.

Tax reform as outlined in the Bradley-Gephardt bill is the best thing I've seen so far. Now, I have had discussions with colleagues who say that Bradley-Gephardt will stifle young and fast-growing companies that our future may depend on. I don't agree. We can promote investment if we simplify our tax system by eliminating most tax preferences and by reducing marginal rates on all income.

For example, we have taxed long-term capital gains at lower rates that ordinary income to spur private investment. That, of course, made sense in a tax system with 70 percent or 50 percent rates; but with rates cut dramatically, special provisions such as the capital gains tax can be eliminated.

There are several reasons this is so. Suppose the top corporate rate dropped from 46 percent to 30 percent, as in the bill. Investors would profit because the company's net income would increase. This would generate potentially greater appreciation in the value of a concerned stock than is possible under current law. And this is very important for young high-tech companies. Venture capital stock appreciates when profits increase. Most successful startup companies will pay close to the 46-percent maximum corporate rate. Lowering the rate to 30 percent would boost the payoff to venture capital by increasing aftertax earnings.

Now, if there were a parallel drop in the individual tax rate from 50 percent to 30 percent, shareowners would pay less tax on dividends.

Closing the rate of the national pool of savings? A low rate, broadly based income tax such as Bradley-Gephardt would let investors make decisions on economic grounds, not tax gimmicks.

I have learned over the years to concur with the adage: If it isn't broke, don't fix it. But the problem, Mr. Chairman, is that we are going broke, and our revenue-raising machinery is breaking down. So we must fix it.

One last word—confidence. Continental Illinois Bank. The Penn Square fiasco was old hat, and the South American loan problem was even older, when Continental Illinois blew up. One of our great banking institutions almost disappeared overnight, just from a lack of confidence.

As Senator Bradley said in his book, "We've lost confidence in the tax system. And as confidence is lost, so are tax revenues."

In reviewing our tax system, the confidence factor is paramount in urging us to get on with the job of overhaul of an outmoded system of taxation.

Thank you, sir.

The CHAIRMAN. Thank you.

Jack Albertine.

[Mr. Jacobs' written testimony follows:]

TESTIMONY BEFORE SENATE FINANCE COMMITTEE
August 9, 1984
RE: BRADLEY-GEPHARDT BILL
BY: HARRY A. JACOBS, JR.

Good Morning....My name is Harry A. Jacobs, Jr., and I am chairman of Prudential Bache Securities.

I started flying airplanes when I was a student at Dartmouth College. Then I was a World War II B-25 instructor and stayed in the Reserves for a few years after that. I have been flying more or less ever since.

Three years ago in honor of my 60th birthday, I rented a restored B-25 in Detroit and went up with a group of friends. The piston rings were hand made and the oil went past them spraying the spark plugs and the engine was constantly misfiring and belching black smoke. Needless to say, none of us enjoyed that ride very much.

The point I want to make of course is that our present day tax system is almost unworkable. It's patched together, does not run properly and, more often than not, misfires. It is incumbent on the leadership of the Congress to study and innovate and rethink our whole process of collecting tax dollars.

To me, major tax reform as outlined in the Bradley-Gephardt bill, is the best thing I have seen come down the road so far.

The NEW YORK TIMES in an editorial of July 7, 1983 said, "could 1983 be the year for a national debate on major tax reform.'

It is clear that 1983 was not the year for debate and now in 1984 with the election practically upon us, no great debate will take place either.

The TIMES also said, "the value of the new proposal is that it may shift the debate from sloganeering to specific discussion of the direction of change."

I urge that we face the "Direction of Change" promptly, squarely and urgently.

As a Wall Streeter of 38 years, I have had many discussions with colleagues who say Bradley-Gephardt will stifle young and fast-growing companies that our future may depend on.

I would like to cover with you the some of the points I made in an article printed in the WALL STREET JOURNAL last year.

> The nation's tax code is a crazy quilt, patched together with investment-distorting special-interest provisions and held up by marginal rates that are too high.
>
> We can promote investment without these inefficiencies if we simplify our tax system-by eliminating most tax preferences and by reducing marginal rates on all income.
>
> Over many years, for example, we have taxed long-term capital gains at lower rates than ordinary income to spur private investment. That made some sense in a tax system with 70% or 50% marginal tax rates. But with rates cut drastically for everyone, special provisions such as the capital gains exclusion can be eliminated on sound investment grounds. There are several reasons this is so.
>
> First, suppose the top corporate rate dropped from 46% to about 30% as in the Bradley-Gephardt bill. Investors would profit because a company's net income would increase. This would generate potentially greater appreciation in the value of a concern's stock than is possible under current law.

This is especially important for young, high-technology or other venture-capital companies. Typically, they lose money early on, pay no dividends, and receive little help from special tax provisions. If all goes well, they eventually turn the corner and their shares rise in value. That's why most people have concluded that a low capital gains tax is crucial for venture capital.

But the corporate tax is an important factor, too. Venture-capital stock appreciates when the comapny's expected profits increase. Since most successful start-up companies will pay close to the 46% maximum corporate rate, lowering the rate to around 30% would boost the payoff to venture capital by increasing after-tax earnings. It would keep investment flowing toward these firms.

Second, if there were a parallel drop in the individual tax rate from 50% to 30%, shareowners would pay less tax on dividends. Since some substantial part of a stock's price is based on the expectation of a future stream of dividends, a reduced tax on dividends could be a powerful factor in improving the share values of young as well as mature companies alike.

Third, bondholders would benefit because the top rate on interest income would be lower. Also, corporations would borrow less for relatively marginal purposes because the interest-expense deduction would be less valuable. In general, both the lower tax rates and the more prudent borrowing policies would raise the national pool of savings.

Fourth, if the distinction between short-term and long-term capital gains were eliminated, investors would be free to make decisions without worrying about the calendar. And should an investor want to realize a gain in less than the present 6-month holding period, the tax bite would be far smaller. In an increasingly volatile economic era, the need for more frequent repositioning of assets without major tax penalty is very real. Of course I believe the recent shortening of the holding period was a real step forward and will substantially aid capital formation.

Some people believe that taxing investment income at a low uniform rate would discourage risk-taking. That is unlikely. Instead, it is more probable that the greater pool of savings would drive interest rates down and funds would switch from debt to equity base and would be in a better position to withstand recessions. This is expecially critical for small or rapidly growing companies.

In the final analysis, a low-rate, broadly based income tax would let investors make decisions on economic grounds, not tax gimmicks. That would strongly enhance capital formation and improve the overall investment climate. With more saving and less non-essential borrowing, with greater tax neutrality and fewer tax-induced distortions, funds would move into the most productive investment markets. The results would not only be pro-investor, but pro-economy as well.

In addition, let me say that most growing small corporations pay very high tax rates. Bradley-Gephardt would create a more efficient tax structure for American corporations, especially smaller ones. Increased tax efficiency means improved capital markets (better prices for common stocks).

A more efficient tax system would tend to put downward pressure on interest rates and perhaps alleviate some of the upward dollar pressure on the U.S. which is causing such pressure on our export industries and many LDC's.

At the same time the bill maintains progressivity in our tax system. It redistributes income among citizens within defined classes. I personally believe that this type of system is favored by the majority of votors as being basically fair. I have learned over the years to concur with the old adage, "if it isn't broke, don't fix it."

The problem is that we are going broke and our revenue-raising machinery is broken so we must fix it and relatively quickly.

And one last word - CONFIDENCE

We have had a real-life Harvard Business School case history in confidence recently.

Continental Illinois Bank - The Penn Square fiasco was old hat and the South American loan problem even older when Continental Illinois blew up.

Rumors spread around the world like prairie fires. Hot money (mostly off shore) withdrew and one of our great banking institutions almost disappeared overnight.

As Senator Bradley said in his "Fair Tax Book," "we have lost confidence in the tax system." As confidence is lost, so are tax revenues. Perhaps in reviewing our tax system, the "confidence" factor is paramount in urging all of us as citizens to get on with the job of overhaul of an outmoded system of taxation.

Mr. Chairman and distinguished Senators of the Finance Committee....and their colleagues on the staff....

Thank you for the privilege of allowing me to speak to you.

Respectfully submitted

Harry A. Jacobs, Jr.

STATEMENT BY DR. JOHN M. ALBERTINE, PRESIDENT, AMERICAN BUSINESS CONFERENCE, WASHINGTON, DC

Dr. ALBERTINE. Mr. Chairman, thank you very much.

I am here on behalf of the American Business Conference and the Coalition To Reduce High Effective Tax Rates.

Let me first speak with respect to the American Business Conference. As you know, Mr. Chairman, we have undertaken a major study of the cost of capital in the United States relative to that of our trading partners, particularly to the Japanese. I have submitted that testimony and that study for the record in the past.

That study shows that the cost of capital in the United States is about three times as high as the cost of capital in Japan. The implications for all sectors of our economy—for the mature sectors, capital-intensive sectors, as well as for the high-growth sectors—are equally compelling and important. Mr. Chairman, we hope that this committee will look at that study and at the remedies which we are suggesting to lower the cost of capital—further reductions in capital gains tax rates, and some form of at least limited dividend deductibility. This proposal would really get at the heart of the cost of capital problem.

With respect to the Coalition To Reduce High Effective Tax Rates, Mr. Chairman, I would like to make three or four comments, if I could.

First, existing high effective rates should not, by this committee or the Congress, be pushed even higher. Currently, there are significant asymmetries in effective corporate tax rates across industries in the United States. For example, the highly successful American Business Conference companies pay effective tax rates which are about 30 percent, significantly above the average in the economy as a whole. In our coalition we have a number of very large corporations that pay very high effective rates. We think it would be a mistake to exacerbate the existing asymmetries in effective tax rates.

Second, we would like to see some move toward the elimination of those discrepancies with respect to effective rates.

Third, we think that consideration of a general tax increase should not divert attention from equitable reform or restructuring of the tax base, particularly as it relates to this problem.

Finally, Mr. Chairman, as we have said continuously to you both in public and in private, we obviously would oppose any attempt to impose a surtax, whether as a permanent device or as a temporary device in a transition period to a new tax system.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Herder.

[Dr. Albertine's prepared statement follows:]

STATEMENT
OF
DR. JOHN M. ALBERTINE
PRESIDENT OF THE AMERICAN BUSINESS CONFERENCE
BEFORE
THE
SENATE FINANCE COMMITTEE
AUGUST 9, 1984

IT IS A PLEASURE TO BE HERE TODAY TO TESTIFY ON WHAT IS PROBABLY THE MOST PRESSING QUESTION OF LONG TERM ECONOMIC POLICYMAKING: HOW OUR TAX CODE SHAPES (OR MISSHAPES) THE PATTERN OF ECONOMIC GROWTH. MY COMMENTS FALL PRIMARILY INTO TWO AREAS. FIRST, I WOULD LIKE TO DISCUSS THE WAYS IN WHICH OUR TAX SYSTEM HAS CONTRIBUTED TO THE VERY HIGH COST OF CAPITAL AND CONCOMMITANT SLOW RATE OF PRODUCTIVITY GROWTH IN THIS COUNTRY. SECONDLY, I WANT TO DISCUSS THE CONCEPT OF THE CORPORATE INCOME TAX AND WHY IT IS A POOR MEANS OF RAISING REVENUE.

LAST YEAR, THE AMERICAN BUSINESS CONFERENCE, A COALITION OF THE CHIEF EXECUTIVE OFFICERS OF 100 MID-SIZED, HIGH-GROWTH COMPANIES, UNDERTOOK A THOROUGH STUDY OF THE COST OF CAPITAL IN OUR COUNTRY. ONE OF OUR MEMBERS, DR. GEORGE HATSOPOULOS, CHAIRMAN OF THE THERMO ELECTRON CORPORATION, SUPERVISED THE STUDY. IN PUTTING THIS STUDY TOGETHER, WE SOUGHT AND OBTAINED THE ADVICE OF MANY CHIEF EXECUTIVE OFFICERS, PROMINENT ECONOMISTS, AND LEADING ENGINEERS.

THE STUDY SHOWS THAT THE COST OF CAPITAL IN THE U.S. IS SO HIGH THAT IT IS ABOUT TRIPLE THE COST OF CAPITAL IN JAPAN. HIGHER CAPITAL COSTS HAVE MEANT LOWER LEVELS OF INVESTMENT IN THE U.S. THIS, IN TURN, HAS LED TO LOWER PRODUCTIVITY GROWTH, BECAUSE THE PRIMARY DETERMINANT OF PRODUCTIVITY IS THE RATIO OF CAPITAL TO LABOR. IN THE 1970'S, OUR LABOR FORCE GREW RAPIDLY, BUT OUR CAPITAL DID NOT KEEP PACE. AS A RESULT, AMERICAN PRODUCTIVITY WAS AT A STANDSTILL FOR ALMOST A DECADE.

OUR STUDY SHOWS THAT HIGH U.S. CAPITAL COSTS HAVE PRECIPITATED THE DETERIORATION IN THE COMPETITIVENESS OF U.S. FIRMS IN WORLD MARKETS. FOR EXAMPLE, A CAR CONTAINING $10,000 OF U.S. LABOR AND CAPITAL WOULD COST ONLY $4,900 IN JAPAN. THE LOWER MARGINAL COST OF CAPITAL IN JAPAN ACCOUNTS FOR $2,300 OF THE COST SAVINGS IN JAPAN.

THE COST OF CAPITAL DIFFERENTIAL BETWEEN OUR COUNTRY AND JAPAN HAS IMPORTANT IMPLICATIONS FOR THE DEVELOPMENT OF THE HIGH TECHNOLOGY SECTOR, THE SECTOR UPON WHICH SO MANY ARE PINNING THEIR HOPES FOR AN AMERICAN ECONOMIC RESURGENCE. THE HATSOPOULOS STUDY SHOWS THAT FOR A PROJECT REQUIRING 5 YEARS OF DEVELOPMENT AND HAVING THE SAME PROBABILITY OF SUCCESS IN THE U.S. AS IN JAPAN, THE ENORMOUS DISPARITY IN THE COST OF CAPITAL WOULD MEAN THAT JAPAN COULD INVEST 2½ TIMES AS MUCH AS WOULD BE JUSTIFIABLE IN THE U.S.

FOR A PROJECT REQUIRING TEN YEARS OF DEVELOPMENT, JAPANESE BUSINESSMEN WOULD BE ABLE TO JUSTIFY SPENDING 5 TIMES AS MUCH AS AMERICANS, SOLELY ON THE BASIS OF THEIR LOWER CAPITAL COSTS. THIS MEANS THAT THERE IS STRONG ECONOMIC JUSTIFICATION FOR OUR TENDENCY TO AVOID LONG TERM INVESTMENTS AND FOR OUR RECENT PREDISPOSITION TOWARDS ACQUISITIONS AND MERGERS.

AMERICANS ARE VERY SMART AND INNOVATIVE, BUT WE ARE NOT FIVE TIMES AS SMART AND INNOVATIVE AS THE JAPANESE. SINCE THE JAPANESE WILL BE ABLE TO UNDERTAKE MUCH MORE RESEARCH AND DEVELOPMENT, THEY MAY WELL BE ABLE TO OUTSTRIP OUR MUCH-HERALDED HIGH-TECH SECTOR.

THE STRUCTURE OF OUR TAX CODE IS ONE OF THE KEY FACTORS CONTRIBUTING TO HIGHER CAPITAL COSTS IN THIS COUNTRY. THE DIFFERENTIAL IN CAPITAL COSTS IS NOT SIMPLY THE RESULT OF THE NUMEROUS JAPANESE INCENTIVES FOR SAVINGS. U.S. FINANCIAL REGULATIONS, THE GLASS-STEAGALL ACT, AND STANDARD U.S. MANAGEMENT

PRACTICES ENCOURAGE U.S. FIRMS TO SEEK EQUITY FINANCING. MOST U.S. CORPORATIONS HAVE A DEBT TO EQUITY RATIO OF 1 TO 3, WHILE FOR MOST JAPANESE FIRMS IT IS 3 TO 1. HOWEVER, SINCE THE RETURN ON EQUITY IS TAXED TWICE IN THIS COUNTRY -- AT THE CORPORATE AND PERSONAL LEVELS -- U.S. FIRMS HAVE TO OFFER A MUCH HIGHER PRE-TAX RATE OF RETURN IN ORDER TO OFFER A COMPETITIVE AFTER-TAX RETURN. THE COMBINATION OF AN INSTITUTIONAL/REGULATORY PREFERENCE FOR EQUITY AND THE TAX TREATMENT OF EQUITY PUTS U.S. FIRMS AT A DISTINCT DISADVANTAGE.

THE ABC IS CURRENTLY LOOKING AT A NUMBER OF WAYS IN WHICH THE COST OF CAPITAL CAN BE LOWERED. ONE OF THE MECHANISMS THAT WE ARE STUDYING RIGHT NOW IS DEDUCTIBILITY OF DIVIDENDS ON NEW CORPORATE EQUITY ISSUES. OUR PRELIMINARY RESULTS SHOW THAT THIS WOULD REDUCE THE REAL COST OF CAPITAL (AFTER DEPRECIATION) AT THE MARGIN FROM 10.7% UNDER CURRENT LAW TO 7.9%.

Another possible mechanism is a further reduction or elimination of capital gains taxes on investments in corporate equity issues. This would reduce the real cost of capital (after depreciation) at the margin to 8.4%. By the way, the comparable figure in Japan is 4.1%.

In a corporate world that is dependent on equity financing, the level of the stock market is a key determinant of the cost of capital. The stock market boom last year did more to lower the cost of capital than did the drop in interest rates or the 1981 legislation liberalizing depreciation.

There is considerable evidence that the 1978 reduction in capital gains taxes helped to foster the advance in stock prices and, as a result, lowered the cost of capital for American business. In fact, I think the reduction in capital gains taxes was the single most important economic policy undertaking of the 1970's. It was a brave, bold step towards creating concrete incentives for long term economic growth.

IN ORDER TO AVOID DISCRIMINATING AGAINST FIRMS THAT RETAIN EARNINGS (AS OPPOSED TO FIRMS THAT PAY DIVIDENDS), THE MOST EFFICIENT WAY TO LOWER THE COST OF CAPITAL MAY BE THROUGH A COMBINATION OF LOWER CAPITAL GAINS TAXES AND DIVIDEND DEDUCTIBILITY FOR NEW ISSUES. THIS WOULD CUT THE COST OF CAPITAL TO 6.7%.

THE SECOND PART OF MY TESTIMONY CONCERNS THE CORPORATE INCOME TAX. I KNOW THAT IN THIS ERA OF DEFICIT DESPAIR NOBODY HAS MUCH PATIENCE FOR BUSINESSMEN WHO COMPLAIN ABOUT HIGH CORPORATE TAXES. HOWEVER, SINCE TAX REFORM IS THE FOCUS OF THIS HEARING, I WOULD LIKE TO DISCUSS WHY WE SHOULD EVENTUALLY AXE THE CORPORATE TAX. IN JANUARY OF 1985, PRESIDENT REAGAN VISITED ONE OF THE MEMBER FIRMS OF THE AMERICAN BUSINESS CONFERENCE. WHILE THERE, HE ANNOUNCED THAT HE THOUGHT THE CORPORATE INCOME TAX SHOULD BE ELIMINATED. I KNOW THAT IN SOME CIRCLES, THIS IS ABOUT AS POPULAR AS POOP SCOOP LAWS. HOWEVER, I THINK THAT FROM THE POINT OF VIEW OF LONG TERM ECONOMIC POLICYMAKING, THE CORPORATE INCOME TAX IS ONE OF THE LEAST EFFICIENT WAYS OF RAISING REVENUE.

FIRST OF ALL, THE CORPORATE INCOME TAX IS NOT PAID BY CORPORATIONS. IT IS PAID BY CONSUMERS, SHAREHOLDERS, AND WORKERS.

- IT IS SHIFTED FORWARD TO CONSUMERS IN THE FORM OF HIGHER PRICES.

- IT IS SHIFTED BACKWARD TO STOCKHOLDERS IN THE FORM OF REDUCED DIVIDENDS.

- IT IS SHIFTED BACKWARD TO STOCKHOLDERS IN THE FORM OF LOWER RETAINED EARNINGS AND THE CONSEQUENT LOWER NET WORTH OF CORPORATIONS.

- IT IS SHIFTED BACKWARD TO WORKERS IN THE FORM OF LOWER WAGES.

What this means is that consumers, stockholders, and workers are paying a hidden tax. Some labor unions support higher corporate taxes and are unaware that it is their members who will actually pay this tax. There is a total lack of accountability for the incidence of the corporate tax, and that is why politicians are so enamored of raising corporate taxes.

There is a second reason why the corporate income tax is poor economic policy. The consensus of tax economists is that most of the corporate tax is shifted backward -- it is a tax on labor and capital. As such, it is really a tax on production and slows the growth of American industry. The corporate income tax makes our most distressing economic problems -- expensive capital and low productivity -- much worse. It is a barrier to economic growth. The burden of the corporate tax should be shifted away from workers and investors, because they are what this economy needs most of all.

THE THIRD AND PERHAPS MOST GRIEVOUS FAULT WITH THE CORPORATE TAX IS THAT IT IS NOT SYMMETRICAL. ALL FIRMS DO NOT PAY THE SAME RATE. GENERALLY, LARGE, ESTABLISHED, CAPITAL-INTENSIVE FIRMS PAY MUCH LOWER TAX RATES THAN SMALLER, RAPIDLY GROWING COMPANIES. THE AMERICAN BUSINESS CONFERENCE -- A COALITION OF 100 FIRMS THAT HAVE ANNUAL REVENUES BETWEEN $25 MILLION AND $1 BILLION AND THAT HAVE DOUBLED IN SIZE OVER THE LAST FIVE YEARS -- STUDIED THIS ISSUE. WE FOUND THAT THE HIGHLY SUCCESSFUL ABC COMPANIES PAID EFFECTIVE TAX RATES THAT WERE NEARLY DOUBLE THOSE OF THE FORTUNE 100.

THE SO-CALLED "PEASE-DORGAN STUDY," COMPLETED BY THE JOINT COMMITTEE ON TAXATION EARLY THIS YEAR CONFIRMED THE WIDE VARIATIONS IN EFFECTIVE TAX RATES. THE TRUCKING INDUSTRY PAID EFFECTIVE RATES AVERAGING ABOUT 40% OVER THE 1980-1982 PERIOD, WHILE THE CHEMICAL INDUSTRY PAID ONLY 4.3%. THE COMPUTER INDUSTRY PAID ALMOST 26%, WHILE THE PAPER INDUSTRY ENJOYED NEGATIVE TAXES.

THIS LACK OF SYMMETRY CAUSES A MISALLOCATION OF RESOURCES. IF YOU COULD MAKE A $10,000 INVESTMENT WHICH WOULD HAVE THE SAME PRE-TAX PAYOFF IN EITHER COMPUTERS OR PAPER, THE TAX CODE WOULD FORCE YOU TO PUT YOUR MONEY IN PAPER. THE EXISTENCE OF THE CORPORATE TAX THWARTS THE EFFICIENT ALLOCATION OF RESOURCES. IT SKEWS RESOURCES AWAY FROM HIGH TAX INDUSTRIES -- OFTEN NEW, RAPIDLY GROWING SECTORS -- AND TOWARDS LOW TAX INDUSTRIES -- FREQUENTLY OLDER, DECLINING SECTORS.

I AM THE CHAIRMAN OF THE COALITION TO REDUCE HIGH EFFECTIVE TAX RATES, AND I WOULD LIKE TO SUBMIT THE COALITION'S STATEMENT FOR THE RECORD. THE MEMBERSHIP OF THE COALITION INCLUDES SOME OF THE MOST SUCCESSFUL FIRMS IN OUR COUNTRY. THESE ARE THE FIRMS THAT ARE PAYING EXTREMELY HIGH RATES. WE ARE IN AGREEMENT THAT OUR NATION'S RESOURCES WOULD BE ALLOCATED MUCH MORE EFFICIENTLY, AND OUR NATION'S OUTPUT AND EMPLOYMENT WOULD BE HIGHER IN THE ABSENCE OF A CORPORATE INCOME TAX.

PROPOSALS TO IMPOSE A CORPORATE SURTAX WOULD ONLY EXACERBATE THE ASYMMETRY PROBLEMS ASSOCIATED WITH THE CORPORATE TAX. A SURTAX WOULD RENDER THE ALLOCATION OF AMERICA'S RESOURCES EVEN LESS EFFICIENT. A CORPORATE SURTAX LOOKS GOOD ON PAPER, BECAUSE IT IS A HIDDEN TAX AND APPEARS TO BE AN EQUITABLE TAX. HOWEVER, BECAUSE OF THE WIDE DIFFERENTIAL IN EFFECTIVE TAX RATES, IT IS A VERY INEQUITABLE TAX. THOSE ALREADY PAYING THE HIGHEST TAX RATES WOULD PAY THE MOST. THOSE PAYING THE LOWEST RATES WOULD PAY THE LEAST. SINCE IT WOULD RESULT IN FURTHER MISALLOCATION OF OUR RESOURCES, IT WOULD CERTAINLY NOT BE CONSISTENT WITH LONG TERM ECONOMIC GROWTH.

GOOD ECONOMIC POLICY STRIVES TO INCREASE NATIONAL OUTPUT AND MAKE OUR ECONOMY MORE COMPETITIVE. TO ME, THIS MEANS THAT WE SHOULD TRY TO LOWER THE COST OF CAPITAL AND REDUCE MARGINAL CORPORATE TAX RATES. WE SHOULD WORK TOWARDS THE OVERALL ABOLITION OF THE CORPORATE INCOME TAX AND REPLACE THE LOST

REVENUE WITH TAXES WHICH DO NOT PENALIZE SAVINGS AND INVESTMENT. IT IS TIME FOR A REVOLUTION IN TAX POLICY. WE MUST TURN FROM A LOW GROWTH STRATEGY TO A HIGH GROWTH STRATEGY. WE MUST TURN AWAY FROM TAXES WHICH PENALIZE PRODUCTION AND THWART SAVINGS AND INVESTMENT AND TURN TOWARDS POLICIES WHICH OFFER INCENTIVES FOR PRODUCTION, THRIFT, RISK-TAKING, AND INVESTMENT.

THANK YOU!

COALITION TO REDUCE HIGH EFFECTIVE TAX RATES

STATEMENT OF:

Dr. John M. Albertine

Chairman

Coalition to Reduce High Effective Tax Rates

BEFORE THE:

Committee on Finance

United States Senate

August 9, 1984

ON:

Major Tax Reform

1725 K Street, N.W. • Washington, D.C. 20006 • 202/872-0885

SUMMARY OF THE STATEMENT OF
DR. JOHN M. ALBERTINE
ON BEHALF OF
THE COALITION TO REDUCE HIGH EFFECTIVE TAX RATES
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

"Hearings on Major Tax Reform Options"

August 9, 1984

* * * * * *

(1) The Coalition to Reduce High Effective Tax Rates seeks to correct the widespread misperception that businesses in general pay very low rates of federal taxes. Regrettably, congressional and media attention to corporate tax rate studies generally ignores the data that document the high rates paid by many industries and companies.

(2) Major tax reform or tax restructuring activities should strive to achieve the elimination of the wide disparities in effective business tax rates, preferably by a substantial reduction in the high effective tax rates paid by many corporate and noncorporate businesses.

(3) These activities should not recommend any mechanisms--such as surtaxes and related concepts--that actually increase the high effective rates already paid by many companies and industries. These are to be avoided, even as "temporary" or "transitional" revenue raisers.

STATEMENT OF DR. JOHN M. ALBERTINE

My name is Jack Albertine, and I am President of the American Business Conference, a coalition of the chief executives of 100 mid-sized, high growth companies. I am appearing today as chairman of the Coalition to Reduce High Effective Tax Rates.

I. Objectives of The Coalition

The Coalition to Reduce High Effective Tax Rates was formed in June 1983 by associations and corporations that share mutual concerns about --

- the long-term effects of high effective business tax rates on economic growth,
- the long-term impact of wide disparities in effective rates on equitable and efficient uses of capital, and
- the near-term possibility that high effective tax rate businesses will be subjected to allegedly "equitable" tax increases in the form of a surtax or other related devices that do not fully recognize the tax burdens already borne by such businesses.

The members of the Coalition, representing more than 500,000 small businesses and approximately 70 of the FORTUNE 500 industrial corporations, are listed in APPENDIX A.

By participating in these hearings, the Coalition seeks to achieve three results:

(1) to call attention to the fact that the present federal tax structure creates wide disparities in effective tax rates paid by businesses;

(2) to urge that primary objectives for federal policymakers who are considering the enactment of either alternative tax systems or of major reforms to existing law should be--

(a) the elimination of existing wide disparities in effective rates, and

(b) the reduction of the high effective rates now borne by whole industries and by individual companies; and

(3) to emphasize that surtaxes and related mechanisms should not be enacted either as "transitional" devices or as "temporary" revenue raising devices in conjunction with general restructuring of federal taxes.

II. The Process Of Long-term Tax Restructuring

The Committee's announcement of these hearings refers to the initial round of hearings on alternative tax systems that was held in 1982. Since that time, considerable attention has been given to fundamental tax reforms and alternative tax systems by federal policymakers, interested taxpayers, business organizations, economists, and the press. The Treasury Department's hearings around the country earlier this year attest to the importance being placed on the tax reform/tax restructuring study requested by the President.

The discussion and debate that are now underway can be informative and enlightening for both the public and federal policymakers. The minimum benefit to be derived from all of this activity should be a significantly improved understanding of the impact that various tax systems have, or can have, on a wide range of economic activities. If we are fortunate, perhaps this process also will eventually produce a new, reformed, simplified and/or otherwise improved structure for computing and collecting federal revenues.

But while in pursuit of this goal, we cannot ignore the problems that are present in the current system. The cumulative effects of these problems have been the primary stimulant for the current initiatives. In other words, we must not become so fascinated by the crafting of new systems or by the reformation of the existing system that we fail to correct -- or we actually worsen -- the circumstances which we set out to address.

One such problem is the wide disparity in effective tax rates that are paid by business entities under current law. It is this problem which led to the formation of our Coalition and to which this statement is directed.

III. High Effective Tax Rates Paid By Businesses

An "effective tax rate" is commonly computed by dividing the amount of taxes actually paid by the amount of net financial income as reported to shareholders. The evolution of the federal income tax structure has resulted in very wide disparities in the effective tax rates of industries and companies which have very similar financial profits. The maximum corporate tax rate is 46 percent, but the use of numerous exemptions, deductions and credits can dramatically lower the overall effective rate, perhaps by as much as 30 to 40 percentage points. Indeed, much attention is paid to such low rate corporate taxpayers.

However, many businesses pay effective tax rates that are higher -- much higher, in fact -- than is generally recognized. The two widely reported annual studies of effective corporate tax rates that frequently are cited to document low effective corporate rates also document the widespread nature of much higher effective rates. Unfortunately, the latter information, contained in the very credible work by the staff of the Congressional Joint Committee on Taxation and by Tax Analysts of Arlington, Virginia, has been largely ignored. APPENDIX B to this statement explains in detail the Coalition's concerns in this area.

Summarizing that material briefly, we note that there are a number of industries whose effective rates have exceeded 23 percent (which is one-half of the top 46 percent corporate rate) over the years and are, in fact, above 30 percent. Among these are beverage companies, computer and office equipment manufacturers, food processors, pharmaceutical companies, retailers, tobacco companies and wholesale-distributors. In general, these industries and corporations within them benefit only modestly from the numerous deductions, exemptions and credits that enable other profitable companies and industries to pay much lower effective rates. Furthermore, many of these industries and most small businesses are also major payers of employment taxes which increase their overall effective federal tax rates even further. However, these facts are very rarely noted by those who discuss and criticize low business taxes.

It is critically important that a thorough study of reforms and of alternative tax systems be based on an understanding of these existing disparities, in order to avoid the repetition of past errors when constructing future proposals.

IV. Major Tax Reform/Restructuring Proposals

Our Coalition is not prepared to recommend the enactment of any particular concept or specific legislative proposal which is currently being discussed. Given the variety of industries and activities represented, we may not be able to reach such a consensus for some period of time. In fact, it is not our purpose to attempt such an agreement.

Nonetheless, we are committed to participating in the public discussion for the purpose of describing the problems created by disparities in effective tax rates and of developing and presenting specific the principles and critieria that we believe should be used during tax reform/restructuring activities.

We offer four points as initial guidelines. We urge that these be considered in the order in which they are listed, thereby drawing important distinctions between the tax reform/tax restructing process and enactment of a tax increase.

1. Existing high effective rates should not be pushed even higher. It is not desirable to consider any proposals that actually worsen the current situation. Thus, any form of "add-on" tax or "base-broadening" that applies to high tax rate companies should be avoided.

2. Elimination of wide disparities in effective rates should be a primary goal. Companies with similar financial profits should not be subject to widely differing tax burdens. Reductions in tax rates are an important means for reducing the upper range of the current disparities. We do not have specific suggestions for increasing the lower range.

3. General federal tax increases should not be allowed to influence the basic tax reform/tax restructuring debate. A revised income tax system or a totally restructured tax system might ultimately define the base from which additional tax revenues are extracted from all taxpayers. But that tax increase should be debated only after the new or revised structure is understood and is judged to meet the criteria listed above. The problems addressed in points 1 and 2 need to be corrected without reference to the tax increase debate. Only after these existing problems are resolved would it be possible to consider general tax increases that are equitable.

4. Surtaxes are unacceptable mechanisms for interim revenue-raising purposes. Reform or restructuring may require more than one year to accomplish. Such a transition period may be analyzed as a short-term revenue loss to the federal government. If tax increases as well as reforms are intended, it is very likely that temporary mechanisms will be proposed to increase taxes during the interim. But this transition period should not be used as a justification for imposing a "temporary" or "short term" surtax that will be removed when the revised system is fully in place. Recent experience with packages of tax increases and spending reductions very strongly suggests that a surtax enacted now would not be eventually accompanied by the fully operative revisions which would allow the repeal of the surtax.

V. Cost Of Capital

An additional benefit of reductions in high effective tax rates would be a reduction in the high cost of capital now borne by many U.S. industries and companies. Furthermore, to the extent that a new or revised tax structure reduces the cost of capital across the board, the economy as a whole will benefit.

In 1983, the American Business Conference undertook a thorough study of the cost of capital in the United States. The study demonstrates that the cost of capital in the U.S. is now about triple the cost of capital in Japan. The result of these higher capital costs has been lower levels of investment in the U.S. This, in turn, has led to lower productivity growth, because the primary determinant of productivity is the ratio of capital to labor. In the 1970's, our labor force grew rapidly, but our capital did not keep pace. As a result, gains in American productivity were at a standstill for almost a decade.

The study shows that high U.S. capital costs have precipitated the deterioration in the competitiveness of U.S. firms in world markets. For example, a car containing $10,000 of U.S. labor and capital would cost only $4,900 in Japan. The lower marginal cost of capital in Japan accounts for $2,300 of the cost savings in Japan.

The structure of our tax system is a key factor contributing to higher capital costs in this country. The differential in capital costs is not simply the result of the numerous Japanese incentives for savings. U.S. financial regulations, the Glass-Steagall Act, and standard U.S. management practices encourage U.S. firms to seek equity financing. Most U.S. corporations have a debt to equity ratio of 1 to 3, while for most Japanese firms it is 3 to 1. However, since the return on equity is taxed twice in this country -- at the corporate and personal level -- U.S. firms have to offer a much higher pre-tax rate of return in order to offer a competitive aftertax return. The combination of an institutional/regulatory preference for equity and the tax treatment of equity puts U.S. firms at a real disadvantage.

To the extent that current law imposes relatively high effective rates of tax on certain industries, their cost of capital is pushed even higher. Thus, the system not only contributes to the overall cost of capital within the economy, it further aggravates the problem for whole sectors of the economy.

VI. Surtaxes

The stated purpose for these hearings and for the Treasury's study is to assess fundamental tax reforms and alternative tax systems; increasing revenues is not the objective.

However, there are many observers who argue that these two objectives will become intertwined in 1985 and 1986. Therefore, the Coalition is taking this opportunity to emphasize one important -- but often ignored -- economic and financial fact:

> A surtax or any related mechanism would be the most objectionable and least equitable means for increasing taxes. By definition, it would fall heavily on those already paying the highest rates while barely impacting those who already pay very little.

A. A Surtax As a Transitional Measure

A surtax would be a step backward in tax policy development. The income tax has developed its numerous exemptions, deductions and credits in large part as a result of taxpayers' intense desires to find relief from high nominal tax rates. To increase those rates through a surtax would only stimulate the already well-developed capabilities of various businesses to seek relief. What is needed now is a significant reduction in such stimulation.

This concern is not merely theoretical. There are real, practical possibilities under which a surtax could be combined with long-term restructuring proposals that will be seriously considered in the coming months. Certain new tax systems such as the "consumable income" varieties probably would require significant transitional periods before becoming fully effective. A surtax could be a very tempting device for raising revenues while the current system is being phased out by a new one.

Unfortunately, one such package has already been unveiled. The recently released Brookings Institution book, Economic Choices 1984, makes just such a proposal. Chapter 5, entitled "Reforming the Tax System," suggests the following as a short-run program while long-term restructuring is underway:

> Such a program of short-run base broadening could go a long way toward meeting the revenue goals set forth in this book, but it is highly unlikely that a consensus on these matters can be achieved very quickly. We therefore urge enactment of a surtax that when added to the revenues provided by short-run base-broadening reforms would assure that the revenue goals ... are met. If half the short-run base-broadening reforms were enacted, they would meet the revenue goals for 1985 with only a 2 percent surcharge. If none were enacted, a surcharge of 6 percent would be necessary to meet these goals. By 1989, however, the tax increase required to meet these targets is so large--$108 billion--that to reach them would require either a surcharge of 19 percent or enactment of half the base-broadening measures plus a 10.5 percent surcharge on personal and corporation incomes.

> *Any surcharge would raise rates levied on a still-distorted tax base and aggravate the distortion between fully taxed activities and partially taxed or exempt activities.* Only the overriding need for reducing the deficit would justify these added distortions, even on a temporary basis. A surcharge would stand out from the fundamental tax structure, underscoring its temporary nature, and would emphasize that work on long-run base broadening must begin immediately. (Emphasis added.)
>
> Pages 90, 92

The quoted proposal acknowledges the Coalition's fundamental theme, which is that existing law presents an extensively distorted tax base and wide disparities in tax rates. Regrettably, the proposal then calls for precisely the wrong approach, both economically and as a matter of legislative tactics. The "short-run base broadening" initiatives include repeal or limitation of several of the features of present law that contribute to disparities in rates. But coupling these restrictions with a "temporary" surtax, particularly by proposing to increase the surtax percentage if reforms are not accomplished, offers double encouragement for beneficiaries of existing law to oppose the reforms. First, if reforms are defeated or watered down, their relatively low effective rates will be changed very little. Second, the higher tax burden then falls on other businesses which must bear the surtax, thereby reducing longer-term revenue-raising pressures. Rather than contributing to a reasonable solution to the inequities of high effective rates, this approach would make it worse.

B. A Surtax Standing Alone

An even worse prospect is the enactment of a surtax, or of rate increases, as a last resort after the debate over reforms and restructuring bogs down. We are disturbed by the seemingly indestructible notion that a surtax is a fair and equitable tax increase. As recently as June 26 of this year, the New York Times appeared to express support for a surtax because it ". . . would ask equal sacrifice of all." This view was expressed after the Times had alleged that effective corporate tax rates have fallen by more than 25 percent since 1981 and had suggested that reforms alone are not likely to ". . . bring in more revenue."

Many members of Congress also express the view that a surtax is fair and equitable. If the consideration of reforms and restructuring is eventually bogged down, surtaxes could be presented as a measure of last resort. This probably would result not so much from an understanding of the mechanism as from a belief that a surtax wuld be a quick and easy escape route.

The inequities of a surtax and descriptions of numerous related mechanisms are described in detail in Section II of APPENDIX B. The following table illustrates the fundamental problem.

Corporate Tax Computation	Company A	Company B	Company C
Net financial income	$1,000	$1,000	$1,000
Less tax adjustments for			
• ACRS, depletion, loss reserves, etc.	(700)	(100)	(100)
• exempt income	0	(500)	0
Taxable income	300	400	900
Tax at 46% rate	138	184	414
Less investment tax credit (ITC)	(100)	(15)	(15)
Tax paid	$ 38	$ 169	$ 399
Effective tax rate	3.8%	$ 16.9%	39.9%
10% surtax on tax paid	$ 3.80	$ 16.90	$ 39.90
Total effective rate (regular + surtax)	4.2%	18.6%	43.9%

VII. Conclusion

An overhaul of the federal tax system or substantial substitution of alternative systems is long overdue, without any revenue raising considerations. The process of analyzing options and developing specific proposals is highly desirable.

But one consideration must not be lost in this process. We cannot afford to allow existing problems to avoid correction or to be exacerbated. The wide disparities in effective business tax rates are a major problem that must be addressed. Any proposal that leaves such disparities intact or that actually worsens the problem by incorporating "temporary" or "transitional" surtax mechanisms is to be avoided.

August 9, 1984

APPENDIX A--MEMBERSHIP OF THE COALITION TO REDUCE HIGH EFFECTIVE TAX RATES

American Business Conference

Beatrice Foods Company

Bristol Myers

Chesebrough-Pond's Inc.

Dart & Kraft, Inc.

General Foods Corporation

General Mills Inc.

Grocery Manufacturers of America

IBM Corporation

Kellogg Company

National Association of Wholesaler-Distributors

National Federation of Independent Business

National Retail Merchants Association

Pillsbury

Procter & Gamble Manufacturing Company

Small Business United

3M Company

August 9, 1984

APPENDIX B--HIGH EFFECTIVE TAX RATES AND SURTAX MECHANISMS

I. High Effective Rate Business Taxpayers

An "effective income tax rate" is commonly computed by dividing the amount of taxes paid by the amount of net financial income reported to shareholders. If two companies have net financial incomes of $10 million and $1 million and each pays $350,000 in taxes, their effective tax rates are 3.5 percent and 35 percent respectively. Thus, a company's effective tax rate is determined by the proportion of net income that is paid as income tax, not the absolute dollar amount of taxes paid by each. Therefore, both a very profitable company that operates in a low profit margin industry and a barely profitable company in a distressed industry can have high effective rates while an enormously successful company that realizes substantial profit margins can pay a low effective rate due to extensive utilization of existing tax provisions. A company that experiences real operating losses has a zero rate, or a negative rate *if* one calculates refunds due to carrybacks as being a negative tax payment.

Perennial congressional and press attention is given to effective corporate tax rate studies. Industries and specific companies that pay very low rates in relation to the statutory 46 percent corporate income tax rate are highlighted in floor statements and feature articles.

The companies and industries that are the subjects of such attention are listed as paying less than one-half of the 46 percent rate, *i.e.*, 23% or lower. A significant number of these are listed as paying less than one-fourth of the statutory rate, *i.e.*, less than 11.5%. Some are even shown to pay negative tax rates due to tax provisions (rather than actual operating losses) that produce loss carryforwards for tax purposes while reporting net income to shareholders.

It is certainly correct to observe that many industries and many major corporations make effective use of a series of deductions, exemptions and credits to reduce their effective corporate income tax rates. But it is also correct, although almost always overlooked, that many industries and major corporations pay much higher rates than their more widely publicized counterparts at the lower end of the tax rate scale. The lack of attention to these taxpayers has allowed an incorrect and troubling public perception to gain credibility, namely that businesses generally and major corporations in particular virtually escape federal taxation. Furthermore, the failure to consider the impact of high effective rates has diverted attention from the distortive impact that the tax system has on investments by and among different industries.

Prior to congressional action on tax restructuring/reform initiatives, a number of myths should be exposed and neglected facts should be considered if the Congress, the Treasury, interested groups and the public are to understand existing business tax burdens and how specific tax proposals would affect those burdens.

A. Numerous industries and major corporations pay high effective income tax rates.

Although public attention is directed to the low-rate examples, two annual effective corporate tax rate studies also provide extensive information regarding high effective rate industries and corporations. TAX NOTES, which is published weekly by Tax Analysts of Arlington, Virginia, has prepared effective corporate tax rate tables for various industries for several years. In the 1982 TAX NOTES special supplement entitled "Effective Corporate Tax Rates in 1981," Appendix A lists 31 industry groups and their effective rates based on the FORTUNE 500 corporations that were surveyed. Of the 31 groups, there were 14 that had an average 1980-1981 U.S. tax rate on U.S. income that exceeded one-half of the statutory rate (i.e., was greater than 23%). Those industries are the following:

Apparel*
Beverages
Diversified Service Industries
Food Processors
Industrial and Farm Equipment
Instrument Companies
Office Equipment
Pharmaceuticals
Publishing & Printing
Retailers -- food
Retailers -- non-food
Soaps & Cosmetics
Textiles & Vinyl Flooring*
Tobacco

(*The 1981 rate exceeded 23 percent. The industry was not included in the 1980 study.)

The corporate effective rate study for 1982 prepared by the Staff of the Joint Committee on Taxation and by the Government Accounting Office for Representative Pease and Representative Dorgan (formerly for Representative Vanik) listed 30 industry groups using different classifications than those in TAX NOTES. Also using somewhat different computational methodologies, Table 1 of the Pease-Dorgan study lists or describes 10 industries (11 when retailing is included as noted below) that had an average 1982 U.S. tax rate on U.S. income that exceeded one-half of the statutory rate (i.e., was greater than 23%). Those industries are the following:

Computers and Office Equipment
Food Processors
Metal Products
Paper and Wood
Pharmaceuticals
Retailing*
Rubber
Soaps and Cosmetics
Tobacco
Trucking
Wholesaler-Distributors

(* The text notes that the deletion of Sears from the retailing category, due to its extensive insurance operations, would raise the industry's rate by 5.5 percentage points to 26.1%.)

Using three-year averages (1980-82) to compensate for single year factors that distort rates, Table 2 of the study lists nine industries (10 when wholesaler-distributors are included) with rates in excess of 23%. They are the following:

x Beverages
Computers and Office Equipment
x Food Processors
x Instrument Companies
Petroleum
x Pharmaceuticals
x Retailing
x Tobacco
Trucking
Wholesaler-distributors (not studied before 1982)

(The "x" indicates groups that are on both this Pease-Dorgan list and the TAX NOTES list above.)

As has been noted by many commentators over a period of years, there are a number of tax accounting judgments used in the two studies on which differing views are held. Furthermore, the use of financial data contained in reports filed with the Securities and Exchange Commission, on which the studies base their computations, may not provide the best means for computing such rates.

While recognizing the problems posed by such matters, the Coalition's review of the studies and their methodologies has resulted in the conclusion that both are sufficiently well prepared to serve important informational functions. The precise effective rate for a company or a industry could vary under different methodologies, but one fundamental fact would not change -- a fact that has been virtually ignored for reasons that are not apparent to us.

> These two annual reports that are perennially cited for their data regarding low effective corporate income tax rates paid by certain large corporations and by whole industries also present extensive statistical information documenting the widespread nature of high effective income tax rates paid by other large corporations and industries.

Therefore, to the extent that the findings of such studies have troubled federal tax policymakers who are concerned about low effective corporate tax rates, the additional information therein regarding much higher effective rates should be of equal significance. The credibility which has been developed by these studies over a period of years should attract attention to both the low and the high effective tax rate data.

But even this expanded reading of the studies does not completely illustrate the disparities among business tax rates. A number of factors have not been taken into account in the effective tax rate debate. These are discussed in the next sections.

B. Effective tax rate studies have not considered the vast number of mid-size and small businesses.

The TAX NOTES and Pease-Dorgan studies have focused exclusively on major corporations, due to the necessity of using required SEC reports as the sources for the data that are used to make the calculations. In fact, the Pease-Dorgan study of 1982 rates by industry classification considered only 213 of the FORTUNE 500 industrial companies and the FORTUNE 500 service companies. The TAX NOTES study for 1981 surveyed 514 leading U.S. firms from the FORTUNE 500 industrial companies and the FORTUNE 50 non-industrial companies, supplemented by additional companies from the FORTUNE second 500 to replace others that experienced losses and, therefore, were not subject to federal income tax.

The necessity of surveying only the largest corporations quite probably results in an understatement of the overall effective rate for an industry as a whole because the largest companies in an industry are more likely to expend the resources necessary to maximize the benefits of existing tax provisions than are their mid-size competitors. This is particularly likely in the distribution services such as wholesale-distribution (which was not studied by either of the two annual reports until 1982) and retailing (where vast numbers of businesses are situated in income levels just below the few very large companies that have been studied).

C. Effective income tax rate studies do not consider the mounting burden of payroll taxes.

The labor-intensity of those industries listed on pages 3, 4 and 5 tends to be higher -- much higher in many cases -- than the sectors benefitting from low effective income tax rates. Therefore, their employment tax burdens, particularly Social Security taxes, have grown dramatically since the early 1970s. Starting at $100 billion in 1967, social insurance taxes (more than 85 percent of which is Social Security tax) are climbing to more than $300 billion in 1987. But this very real tax burden is not reflected in the effective income tax rates. For many businesses, particularly smaller companies in service industries, payroll taxes equal or exceed in dollar amounts the federal income taxes paid. Thus, while rarely mentioned, these taxes have become the major tax issue for such businesses.

D. The vast numbers of unincorporated businesses are never discussed.

High marginal tax rates on sole proprietors and partners, ranging up to 50 percent, exceed even the maximum 46 percent corporate rate. Yet these businesses, to whom the employment tax burdens may be even more important, are not taken into consideration when generalizations are made concerning business tax rates.

E. Businesses continue to pay very sizable amounts of federal taxes.

One outgrowth of the attention given to low effective rates appears to be a perception that the corporate income tax has been virtually repealed. Yet, the corporate income tax has produced $50 to $70 billion annually from 1976 through 1981 and, after the recessionary trough of 1982 and 1983, is projected by the Congressional Budget Office (CBO) to generate more than $80 billion annually by 1987 and by the Office of Management and Budget (OMB) to produce more than $100 billion by that year. Such amounts certainly are not being generated by a business community that pays overall effective income tax rates of 10 percent, 5 percent, or 0 percent. Instead, they are being paid and will continue to be paid to a significant degree by those industries and companies with much higher effective rates.

Furthermore, more than 50 percent of the mounting social insurance taxes are paid by corporate and non-corporate employers and by self-employed individuals, which significantly increases the overall effective federal tax rate on business income. Estimated by CBO to be approximately $320 billion in 1987, these taxes are deductible by employers, thereby reducing the dollar amounts received as corporate and non-corporate business taxes. If $80 billion is paid by corporate employers (with a similar amount withheld from employees) and their marginal rate is 46%, social insurance taxes alone reduce corporate income taxes by more than $35 billion. This is a rough calculation, but the order of magnitute appears reasonable.

Thus, even with incomplete information, it is apparent that significant business sectors pay effective _income_ tax rates, not to mention overall tax rates, that are much _higher_ than the minimal percentages paid by industries and companies that are perennially subjected to intensive public scrutiny.

II. _The Inequity Of Surtax Mechanisms_

Consideration of effective tax rate burdens is much more than an academic inquiry. It is a matter that should have a profound effect on federal tax policy deliberations. The most immediate concern is the potential enactment of a surtax (or a similar mechanism) on businesses. This is of concern as a transitional mechanism for a new tax system, as well as for a revenue raising device.

A. _The Basic Surtax_

In its most pure and simple format, a surtax applies a percentage rate to the amount of income tax actually payable in one year under the regular computations. The result is an additional amount of tax that is payable for that year. Variations of this simple mechanism would apply the surtax percentage to tax liability computed before tax credits, or to taxable income, or to modified computations of taxable income.

A surtax is often presented as a simple and equitable means for increasing taxes on business because it can apply uniformly to all business taxpayers. This perception has been nurtured by the belief that businesses -- or at least major corporations -- _all_ pay low effective rates of tax and therefore would be rather evenly impacted by a surtax.

But a surtax is _not_ uniformly applicable, for the simple reason that all businesses do _not_ pay the same or even similar effective tax rates, as has been outlined above. In fact, a surtax would impose the heaviest burden on those firms that already pay the highest effective tax rates while falling much less heavily -- if at all -- on equally profitable firms that utilize an array of deductions, exemptions and credits to reduce or eliminate taxable income and/or tax liability.

Although oversimplified, the following three examples illustrate this point.

VARYING EFFECTS OF A PURE SURTAX

Corporate Tax Computation	Company A	Company B	Company C
Net financial income	$1,000	$1,000	$1,000
Less tax adjustments for			
• ACRS, depletion, loss reserves, etc.	(700)	(100)	(100)
• exempt income	0	(500)	0
Taxable income	300	400	900
Tax at 46% rate	138	184	414
Less investment tax credit (ITC)	(100)	(15)	(15)
Tax paid	$ 38	$ 169	$ 399
Effective tax rate	3.8%	16.9%	39.9%
10% surtax on tax paid	$ 3.8	$ 16.9	$ 39.9
Total effective rate (regular & surtax)	4.2%	18.6%	43.9%

Although starting with identical financial incomes, the three hypothetical firms are treated much differently for tax purposes. The provisions of the Internal Revenue Code which reduce the taxable incomes and tax liabilities of Company A and Company B have been debated and reviewed over the years. Their benefits have been analyzed at length. Some have been expanded, and some have been curtailed. All have been subjected to prolonged scrutiny. Thus, they have generally been judged to be desirable, to varying degrees.

The issue is not whether any specific deduction, exemption or credit -- or any industry-wide grouping of such provisions --

is excessive. The Coalition is not suggesting that any specific tax provision be changed as a means of raising someone else's taxes. Our objective is to reduce the high effective rates that our members pay. Simply repealing most of the provisions that benefit low effective rate taxpayers would also increase taxes for our members because virtually all businesses utilize one or more of these provisions to some extent.

Rather, the issue that we raise for consideration is the fact that a surtax intensifies the assymmetries in effective tax rates because it falls heavily on those companies and industries that are able to realize only a modest benefit from all existing tax provisions, such as Company C, while falling very lightly on those who already realize massive tax benefits.

The pure surtax illustrated above is the simplest means by which to illustrate the inequity of the surtax concept. But more complex approaches can retain significant surtax attributes no matter what the label.

For example, a surtax applied to tax liability before tax credits are claimed allegedly would "broaden the base" somewhat. In the above example, a 10 percent surtax applied to "Tax at 46% rate" would produce the following results:

	A	B	C
10% surtax on pre-credit tax	$13.80	$18.40	$41.40
Total effective rate (regular & surtax)	5.2%	18.7%	44.0%

In an attempt to "broaden the base" even further, a 10 percent surtax applied to "Taxable income" would produce the following results:

	A	B	C
10% surtax on taxable income	$30.00	$40.00	$90.00
Total effective rate (regular & surtax)	6.8%	20.9%	48.9%

In both situations, the impact of the surtax is to increase substantially the already high effective tax rates of Company C.

B. Related Proposals

Attempts to soften or eliminate this impact may be well intended, but the actual effects of various "hybrids" must be scrutinized very carefully. Their labels are merely that--labels. Their substance is extremely important. Proposals to impose a tax on a broadened base that takes into account regular taxes paid may sound more equitable. But the numbers can illustrate a contrary result.

For example, consider the following illustrations of the same three companies under a more complex set of rules for a new tax. The example begins with "Taxable income" (and "Tax paid") as computed in the example on page 11.

New Tax Computation	Company A	Company B	Company C
Taxable income (regular computation)	$ 300	$ 400	$ 900
Tax paid (regular computation)	38	169	399
Add-backs to taxable income for exempt income, ACRS in excess of straight-line/ADR	300	300	50
New base income	600	700	950
Deduction for regular tax paid	(38)	(169)	(399)
New base taxable income	562	531	551
2% of new base taxable income	$11.20	$10.60	$11.00
Total effective rate (regular & new)	4.9%	18.0%	41.0%

The purpose of this approach could be described as a form of minimum tax. The result, nontheless, is to increase C's tax rate by virtually the same amount as for A and B. Variations in numbers, assumptions and add-backs certainly will vary the results, and this example is not intended to represent a wide variety of proposals. It is intended to demonstrate the fact that very extensive analysis of each new proposal is essential.

STATEMENT BY PETER D. HERDER, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, DC

Mr. **Herder**. Mr. Chairman, members of the committee, my name is Peter Herder. I am a homebuilder and developer from Tuscon, AZ.

Mr. Chairman, I understand you went to school there for a year. Most people who stay for a year stay for life.

The **Chairman**. That's right.

Mr. **Herder**. I appear here today on behalf of the more than 125,000 members of the National Association of Home Builders, of which I am president. We appreciate the opportunity to appear today to express our views on tax reform. You are to be commended for holding these hearings to explore ways to make the Tax Code more equitable and streamlined. We would like to give the committee NAHB's view of the current housing situation.

Our survey of builders shows high interest rates as causing delinquency difficulty in approving buyers, and a buildup in inventory. Our July forecast shows fourth quarter mortgage rates at 15.6 percent and first quarter 1985 at 15.8 percent. The August forecast may be a little bit better due to recent market rate declines. Really, the threshold for buyers to back out of the market is between 12 and 13 percent, and traffic just drops off drastically.

This committee has a difficult balancing task to perform. On one hand you must look at reform with an eye toward reducing the deficit.. On the other hand, you must not abandon those incentives which stimulate capital formation, encourage savings, and maintain economic growth.

This committee must recognize the magnitude this decision will have on national housing policy. Your collective decisions are even more significant because of the recent shift in housing policy in this country. Federal housing production programs have been virtually eliminated. Since 1980, Federal budget authority for housing assistance has declined from $27.8 billion to an estimated $8 billion in 1984.

This Nation is one of the best if not the best housed nation in the world. This did not happen without a deliberate national policy. The cornerstone of that policy now rests with the Tax Code. Changes in tax incentives related to housing and housing finance will therefore impact millions of renters and potential home buyers.

Tax revision should not be viewed in isolation for its implications for housing. Tax policy is of major importance to those who construct housing, to those who finance housing, and to those who eventually reside in it. We need a consistent tax policy which reaffirms our national commitment to affordable, quality housing, both for home ownership and for rental housing. Protection of this principle should be a priority. The home owner's mortgage interest deduction is the most visable evidence of this commitment. Any modification of the home owner's mortgage interest deduction would have a devastating effect, especially on affordable housing that relates to the first time home buyer.

Certain principles should be reaffirmed:

(*a*) Home ownership should be encouraged.

(*b*) A suitable framework for the evolution of the system of housing finance should be maintained, especially as related to the federally related secondary market institutions such as Fannie Mae, the Federal Home Mortgage Corporation, and Ginnie Mae.

(*c*) Incentives for the construction and ownership of rental housing should be maintained.

(*d*) The tax system should foster savings and private capital formation.

(*e*) Certainty in the tax law should be encouraged; tax changes create investment uncertainty, and future changes should attempt to minimize potential market dislocations, and long-range planning is essential.

(*f*) Reform should facilitate tax compliance with an eye toward deficit reduction.

The CHAIRMAN. Is that about it?

Mr. HERDER. That's about it. [Laughter.]

The CHAIRMAN. It sounds pretty good.

Mr. HERDER. A good place to quit.

The CHAIRMAN. Mr. Slesinger.

[Mr. Herder's prepared statement follows:]

STATEMENT OF
NATIONAL ASSOCIATION OF HOME BUILDERS
BEFORE THE
SENATE FINANCE COMMITTEE
ON
PROPOSALS TO REVISE THE FEDERAL INCOME TAX

August 7, 1984 and August 9, 1984
Washington, D.C.

Mr. Chairman and Members of the Committee:

My name is Peter Herder and I am a homebuilder from Tucson, Arizona. I appear here today on behalf of the more than 125,000 members of the National Association of Home Builders (NAHB), of which I am President. NAHB is pleased to present its views on revision of the tax system.

NAHB is concerned that many of the tax proposals currently being considered reduce complexity at the expense of economic efficiency and fairness and could lead to shifts in national policy. Tax incentives are a major component of housing policy, especially since direct housing subsidy programs have been virtually eliminated. It should be noted that NAHB has supported this policy direction as part of a general approach to reduce growth in government spending and encouraging private sector capital formation. It has been our belief that free market incentives are more effective than other alternatives.

Because of the effect of tax policy on housing and housing policy, tax revisions should not be viewed in isolation from other changes in housing policy and programs. Tax policy is of major importance to those who construct housing, to those who finance housing, and to those who eventually reside in it. We need a consistent tax policy which reaffirms our national commitment to affordable, quality housing -- both for homeownership and for rental housing. A consistent policy of support for decent housing and homeownership has been a national commitment for more than fifty years.

The homeowner's mortgage interest deduction is the most visible evidence of this commitment. Any modification of the homeowner's mortgage interest deduction would have a devastating effect on both the housing market and the economy. We believe very strongly that this provision of the tax code should remain.

The effect of tax policy upon housing extends to all elements of the housing industry. For example, the tax portion of the 1984 deficit reduction package recently agreed to by the House and Senate Conferees will amount to approximately an $8 billion tax increase for housing and the real estate industry. The average taxpayer and businessman has little knowledge of obscure tax code provisions involving partnerships allocations, like-kind exchanges, original issue discount accounting, and the capitalization of construction period interest and taxes. Yet each of these changes will increase taxes and the cost of capital for housing and ultimately the consumer, through higher rents or purchase prices.

NAHB is reviewing various tax proposals, but as we look at them, we need to keep in mind certain basic principles.

° Homeownership should be encouraged. Tax changes should not increase the cost of housing, particularly for those who are just entering the housing markets. Tax changes should maintain existing property values and should not result in diminishing the value of homeownership -- which is often a family's major investment. Homeownership is also important to to the community. It provides for social and political stability.

° A suitable framework for the evolution of the system of housing finance should be maintained. Dramatic changes are occurring in the way capital is accumulated to finance homes and rental housing. The marketplace has been able to utilize the existing tax framework to adjust to new trends which have developed. While far from perfect, existing tax rules should not be revised in such a manner which would jeopardize the evolutionary growth of the mortgage finance system and the important role which current players including FNMA, FHLMC, GNMA, and a variety of private financial institutions play.

° Incentives for capital investment, particularly for the construction and ownership of rental housing, should be maintained. Special consideration should be given to low income housing needs. We face a shortage of rental housing. New construction based upon existing tax provisions will not overcome the rental housing shortfall. Incentives directed toward capital formation for rental housing, particularly ACRS depreciation allowances and the use of partnerships as a means of capital accumulation for investment in rental housing, should be maintained and strengthened.

° The tax system should foster savings and capital formation. Economic productivity and growth requires private capital formation. Incentives to save and invest should remain as an integral part of the tax system and new savings incentives should be considered.

° Frequent changes in the tax law should be discouraged. Tax changes create investment uncertainty. Future changes should attempt to minimize potential market dislocations which the changes could create. Certainty which permits long-term planning is essential.

° Reform should facilitate tax compliance with an eye towards deficit reduction. Reform for the sake of reform is not enough. While the current law is far from perfect, for many taxpayers who use the standard deduction, it is relatively simple. It does promote desirable economic and social goals. It is relatively fair in terms of being progressive. Any change to a true flat rate tax will place a higher tax burden on low and middle income taxpayers unless appropriate exceptions are made.

FEDERAL DEFICIT

Although the Congress is moving toward enactment of a "down-payment" on the federal deficit in 1984, the need for additional reductions remain. NAHB shares the view of most political leaders and economic experts of this country:

Budget deficits of the magnitude we are experiencing, and are likely to experience through the remainder of the decade, require a bipartisan plan. Last year NAHB developed a grassroots campaign focusing on the serious effect deficits have on continued economic growth and recovery. Deficits are indeed America's "ticking time bomb."

Deficit reduction should not, however, be a signal to increase taxes at the expense of housing. The housing and real estate industry in the recent tax bill paid its "fair share" and arguably more than its fair share in deficit reduction. The 1984 "down-payment" raised approximately $8 billion in revenues on the real estate industry through 1987. This is about 15 percent of the total revenues raised. Future deficit reduction should be broad-based and should not place such a heavy burden on housing.

TAX POLICY AND HOUSING POLICY

In light of the previously discussed principles, we want to reiterate the importance of tax policy as it relates to homeownership, mortgage finance and rental housing.

Homeownership

Incentives for homeownership should be continued and homeownership should be encouraged. The most obvious incentive for homeownership is the mortgage interest deduction. Any system which eliminates the mortgage interest and property tax deduction would substantially raise the cost of housing for many households. The mortgage interest deduction makes ownership of a home affordable for many Americans. Take for example, a married couple with two children filing a joint return. Using the tax rates effective July 1, 1983, and assuming a family income of $35,000 per year, the mortgage interest deduction helps this family qualify for a $70,000 house. Without the mortgage interest deduction, the same family could qualify for only a $53,000 home. With the average price of a new home in the $70,000 range, the mortgage interest deduction becomes an important element in permitting ownership of a home.

While most proposals being considered retain the mortgage interest deduction, the effect of a dramatic reduction in tax rates upon the deduction should also be considered. From a tax point of view, the value of the deduction decreases as marginal tax rates decrease. Therefore, this assistance for homeownership diminishes as marginal tax rates decline. Presumably, the reduced value of the deduction will be compensated for by provding lower tax rates, thereby giving most taxpayers additional capital to use for a home purchase. This, however, may not be the case and special provisions for homeownership may be necessary.

Not only could housing affordability suffer through changes in the mortgage interest and property deductions, but property values could also diminish. This could also could occur with a dramatic reduction in marginal tax rates. Such action would adversely impact the savings of many Americans who view homeownership as their major investment. Care must be taken to avoid such a result.

Housing Finance

The present housing finance system is undergoing tremendous change. Tax revisions should point toward improving the access of housing finance to the capital markets. Current housing finance delivery systems should not be jeopardized in exchange for new or untried approaches.

The growing interest of financial markets in mortgages as investment is an important development for housing. The tax laws should provide a workable framework to permit new approaches while retaining established methods of housing finance.

The following points regarding mortgage finance should be considered in reviewing the tax law.

- Mortgage-backed securities are a principal tool for raising mortgage money in capital markets. The tax law should encourage the growth and development of mortgage backed securities by federally related and private entities.
- Builder financed home purchases utilizing the installment sales provisions of the tax code are an important means for builders to provide the capital necessary for a home purchase, similar to current techniques for financing automobiles and appliances. This important financing tool should be permitted to continue.
- Tax exempt bonds issued by state and local governments continue to be an effective means of promoting the development of moderate income rental housing and providing homeownership opportunities for first-time homebuyers. This year, Congress reaffirmed the essential tax exempt bond-financed housing programs.

° To meet the mortgage capital needs of the eighties and beyond, it is essential to lower tax barriers to foreign investments in the United States.

Rental Housing

Multifamily housing is an essential aspect of any housing policy. NAHB anticipates a rental housing shortfall of more than 100,000 units per year over the next decade. Incentives for continued investment in multifamily housing are necessary. Yet, the history of recent tax legislation affecting residential structures has been a progressive diminution of the tax benefits associated with this type of investment. The requirement that construction period interest and taxes (IRC Section 189) be capitalized was introduced in 1976. No industry other than real estate construction is required to capitalize interest. Residential real estate also does not have the advantage of the investment tax credit, except for the rehabilitation of historic structures. In addition, the alternative minimum tax often affects capital gains associated with real estate investments more than it affects investments in other types of assets, particularly corporate equities or bonds.

Your future decisions in this area are especially important because the focus for housing policy has shifted towards the tax writing committees. Federal housing production programs have been virtually eliminated. For example, since 1980, federal budget authority for housing assistance has declined from $27.8 billion to an estimated $8 billion in 1984. (See Appendix A.)

From an investment point of view, rental housing has often not been attractive. Intensive management to maintain an adequate income stream is necessary. Costs of maintaining rental property have increased considerably in recent years. In addition, income generated from rental property is lower than for other types of property.

Residential rentals do not generally carry CPI inflation increases, and the income of residents can only support a certain level of rent. Therefore, market rents generally do not create an income stream which is competitive with other types of investments. In addition, rent control in many jurisdictions has kept rents at below market levels.

As a result, tax revisions should establish special incentives for rental housing to permit it to be competitive with other types of investments. Tax changes should not have the effect of driving capital away from residential housing at a time when more, not less, capital is needed. Otherwise, additional direct government subsidies will be necessary.

CONCLUSION

In conclusion, the American economy as well as the housing industry will face severe challenges over the next several years. Tax revisions must maintain a commitment to affordable, quality housing. Housing - both owner-occupied and multifamily - are a principal source of economic growth. This commitment is more than economics; it extends to providing every American with a stake in their own community and our nation.

Deficit reduction, tax simplification, and affordable, quality housing must be given equal priority in any tax revision proposal.

Changes should consider the implications for homeownership, housing finance, multifamily housing, savings and capital formation, and should foster investment certainty and long-term planning. NAHB is studying the implications of various tax proposals but has not reached a definite position on the alternatives. We look forward to working with your Committee and the Congress on this important issue.

Thank you for the opportunity to present our views. I would be happy to answer any questions you may have.

APPENDIX A

BUDGET AUTHORITY FOR HOUSING ASSISTANCE

($ BILLION)

	1980	1981	1982	1983	1984
Budget Authority	27.8	26.1	13.9	8.9	8.0*

* Estimate

Source: Low Income Housing Information Service

STATEMENT OF SCOTT L. SLESINGER, EXECUTIVE VICE PRESIDENT, NATIONAL APARTMENT ASSOCIATION, WASHINGTON, DC

Mr. SLESINGER. Over many years, and certainly since World War II, affordable housing for all Americans has been a national priority—whether it be owner-occupied or rented. Tax expenditure statistics clearly show that most incentives have been tilted sharply toward ownership housing. In 1981, the Congress and this committee decided to build incentives into the tax laws to retain and spur private investment for multihousing needs. These incentives have helped the industry provide affordable rental housing through most of the country over the last 3 years.

Most of the tax-reform proposals would eliminate or restrict many of the advantages that are enjoyed by rental real estate. At least one of these proposals would change depreciation schedules enough so that a real estate investor's aftertax return would be significantly less than under current law. Additionally, the removal of the capital gains exclusion and the further changes in income averaging, another reform proposal, would greatly diminish the reasons why people invest in rental real estate.

Our problem is that rental housing cannot compete equally with other businesses. Unlike investments in businesses outside housing, supply and demand does not necessarily set prices. If costs go up, rents can only go up enough that they don't encourage renters to take advantage of home ownership, or, at the other end of the spectrum, make the housing unaffordable. If rent prices do rise, unlike any other commodity, the municipality could put on rent controls. Should J.W. Marriott raise his rents $10 a day, nobody notices, how ever, if one of my owners tried that, he would be on the 6 o'clock news.

Rents are seldom if ever high enough to allow owners to pay the operating expenses, mortgages, and costs of rehabilitating buildings. Therefore, only when new owners invest in a property are funds available to fix up our aging housing stock. If a flat tax is enacted, rental housing values would plummet, and rehabilitation of existing buildings would become financially unfeasible. The eventual cost of enacting such a change would be catastrophic to our economy.

The sponsors of the flat tax proposals have, in the main, modified their bills to protect the incentives for home ownership, and that is quite understandable for the obvious political reasons. And that is where the flat tax starts to get bumpy. If home ownership is protected in an otherwise flat tax world, rental housing will become unaffordable.

The Tax Code is complex, too complex; but the tax incentives were created for a good reason—namely that the Congress believed tax incentives would encourage certain types of investment that otherwise would go undone or would have to be heavily subsidized through the appropriations process, probably through an inefficient governmental mechanism.

We are concerned that there is too much relevance on the proposition that the flat tax proposals are as advertised, revenue neutral, when in fact they are going to require in their place vast amounts of Federal spending to provide housing for a substantial minority of our population.

Thank you, Mr. Chairman, for this opportunity to testify. I will be happy to answer any questions which you or any of the other members of the committee have at this time.

[Mr. Slesinger's written testimony follows:]

TESTIMONY OF
SCOTT L. SLESINGER
NATIONAL APARTMENT ASSOCIATION

Good morning - my name is Scott L. Slesinger. I am Executive Vice President of the National Apartment Association, a trade association which represents nearly 50,000 owners, builders and managers of nearly two million apartment and condominium units across the country. I welcome this opportunity to testify on behalf of our members at these Hearings on Fundamental Tax Reform.

I'd like to talk to you this morning about our business -- which is providing affordable homes for those Americans who have chosen rental housing ... and particularly those who depend on rental housing.

Over many years, and certainly since World War II, affordable housing for all Americans has been a national priority, whether it be owner-occupied, or rented. However, as tax expenditure statistics clearly show, most incentives have been tilted sharply toward ownership housing. In addition, there has also been a marked decline of direct cash subsidy programs for low-income families who overwhelmingly are renters. In 1981, however, the Congress decided to build incentives into the tax law to retain and spur private investment for multi-family housing needs.

In most other investments such as stocks or bonds, the investor's contributions of capital can be controlled by the investor with a great degree of precision. Rental real estate is different: when the typical investor buys his first unit, not only does he make sizeable initial capital outlay, probably he has guaranteed himself a negative cash flow of $100 - $200 a month per unit for at least the first year or more. And of course that negative cash flow is assuming that the winter is not too cold, the summer is not too hot and the residents pay on time. At the present time, the tax law gives some assistance to minimize the early negative after-tax cash flow, thus increasing the desirability of rental real estate as an investment.

Right now, the typical person involved in real estate is going through a tax shock syndrome, based on the instability and uncertainty of tax laws affecting the planning of transactions -- transactions which typically span many years to complete. Today, we sit here discussing far-reaching tax proposals while the Tax Reform Act of 1984, signed by the President on July 18, 1984 has just made significant real estate tax changes that are, in some cases, effective retroactively. How can we plan our transactions today, while the all-important tax landscape is as changeable as the political atmosphere in Washington? We are just now trying to cope with the far-reaching changes in the tax laws that were made in 1981 and 1982.

Unlike the sale and purchase of stock, a real estate transaction usually takes many months in the making and the investors problems are now compounded because of the significant instability of our tax laws. This is leading to increased confusion, hesitation and planning costs.

Given these problems, policy analysts should very properly ask what the net effect of all these changes will have on the industry that provides rental housing. Certainly, the provision in the 1984 tax bill to recapture all accelerated depreciation at the moment an installment sale is made -- even if the seller has received no cash with which to pay the tax -- will radically affect the transfer of real estate. The repercussions could be dramatic, especially now as we also watch mortgage rates soaring back into the stratosphere. The last time rates zoomed, the typical purchase could be done only by seller financing. We also know that the changes in the partnership and accounting rules will act as a major disincentive -- particularly for small partnerships investing in real estate where the new proposed laws push tax accounting treatment even further from economic reality by requiring imputed interest of over 15% for owner financing below 14.25%

We, who are in the business of providing affordable rental housing for Americans have a second major concern: We compete with owner-occupied single family homes, co-ops and condominiums.

The tax laws treatment of rental housing vis a' vis single family, limits to a great degree the price of rents irrespective of the cost of providing the rental housing. To a large extent, rents are limited by the minimum price of ownership housing with its built-in tax advantages of mortgage interest deduction that allows most homeowners to reach the threshold for itemizing deductions. This cornerstone incentive for homeownership is a critical governmental policy that discourages renting by all but the poorest households. Other sections of the code to encourage homeownership have serious implications to the economy as a whole. For instance, today $10,000 plus income generated of investment interest is deductible. At the same time, wealthy taxpayers can borrow and deduct unlimited amounts of interest if their investment is in a principle residence. With the need of investment in job-creating industries, the encouragement to invest so much in housing seems questionable economic policy.

Another major concern of our industry is the federal deficit and what we generally perceive as an absolutely urgent need to raise additional tax revenue and limit spending to reduce the federal deficits. Our industry and most American homeownership is dependent on financing and re-financing so we are very concerned with the level and changes of interest rates. As we have seen in just the last few years, if interest rates become too high, there is no new construction and there is considerably less change of ownership of existing structures.

Just as one of our members doesn't invest in real estate with a $200 a month negative cash flow without an expectation that he will get out of the red in the relatively near future, we don't believe that the United States Treasury can afford a $15 billion a month negative cash flow without major stresses and strains in our economy and particularly in real estate. If we get high interest rates -- with, or without high inflation -- some of our members, who are developers, may go out of business permanently. It happened in the early 1970's, when interest rates soared. If the average investor no longer can hope to see a reasonable opportunity for profit, he will move his investment to another area of our economy. Experience has taught the building owner that if there is inflation, he must consider getting out of renting because his costs are going up faster than his rents. This is not the time for "tax reform," if activity in that sphere is used as an excuse not to attack the deficit problem.

So, although this is the day to be innovative about tax reform, we feel compelled to resurrect a very old idea, namely that of a small tax rate increase, or a surtax on the existing tax structure. We're not in favor of higher taxes, but we are in favor of rapid deficit reduction. Tax rate changes or a surtax would be least disruptive in the short term to the real estate industry

-- and the rest of the economy. This approach has a major advantage in that we can still go ahead and plan transactions with some awareness of what tax laws might govern us.

Turning to the reform proposals of the day, we believe it is critically important that the Congress understand the impacts of the various reform proposals on the multifamily housing industry, and by the collective term I mean not only the owners, developers and managers, but also the residents.

Moreover, we hope that this public policy debate will also take into account the impact of the average American trying to decide whether to rent, or buy. If for example, these tax reforms skew individual decisions toward home ownership, and away from investing in rental housing, we could find the less affluent being crowded out of an ever-dwindling supply of rental housing. Here again this raises the possibility of inadvertently increasing the need for direct government subsidy.

FLAT TAX REFORM PROPOSALS

Turning to the various forms of flat tax proposals, variously denominated FAST, FAIR, FLAT, SELF, at this point we have no positions, pro or con on any one overall bill. However, we do believe that the various provisions of this type measure, whether fair, fast, or flat would drastically change the incentives for capital formation, particularly in the multi-family housing industry.

At least one of these proposals would change depreciation schedules enough so that a real estate investor's after-tax return would be significantly less than under current law. Additionally, the removal of the capital gains exclusion and the further changing of income averaging would greatly diminish the after-tax rewards of investing in real estate. This is especially so because the use of a tax deferred-like kind exchange is much more impractical for most real estate investors who simply want to reinvest their capital in new projects.

Unlike the many investors in the capital markets for stocks and bonds who hold their investment for relatively short time , the multi-family dwelling owner is in for the long term. He is expecting a good part of the reward for the risk that he takes to be in the form of capital gain. Because most of the new flat tax proposals do not permit indexing of the basis of capital assets, the proposals to eliminate the capital gain exclusion and to further change income averaging will result in a major disincentive to anyone who would otherwise consider buying a multi-family building. We believe that the cumulitive effect of these provisions would be extremely damaging to capital formation in real estate.

Rental housing cannot compete equally with other investments. Unlike investments in businesses outside housing, supply and demand does not necessarly set prices. If costs go up, rents can only go up enough that they don't encourage renters to take advantage of homeownership or at the other end of the spectrum make the housing unaffordable. Or if prices do rise, unlike any other commodity, the municipality could put controls on rent. If J.W. Marriott raises his "rents" $10 a day, nobody cares. If an apartment owner took the same action, it would make the 6:00 news. Without tax incentives, capital will flow out of rental housing into less restrictive industries and people will easily find less aggravating ways to invest their money. This may be a plus for "capital formation", but a significant deterioration in the quality of life for those Americans who cannot afford homeownership.

Rents are seldom, if ever high enough to allow owners to pay the operating expenses,mortgages, and cost of rehabilitating buildings. Therefore, only where new owners invest in a property are funds available to fix up our aging housing stock. If a flat tax is enacted, rental property values would plummet and rehabilitation of existing buildings would become infeasible. The eventual cost of enacting such a change would be catastrophic to our economy.

In a perfect "flat" tax world our industry could, for our own benefit, oppose the homeownership deductions. But in the real world, the homeownership deductions, is in the minds of the voting middle class, tantamount to the promised "pursuit of happiness." Urging its repeal to create a real flat tax despite its obvious advantages to our industry is not practical. In fact, even the sponsors of the flat tax proposals have, in the main, modified their bills to protect the incentives for homeownership.

And that is where the flat tax starts to get bumpy. If home ownership is protected in the otherwise flat tax world rental housing becomes unaffordable.

Take the following example. At today's interest rates, the U.S. Treasury Department effectively requires lenders to finance mortgages for apartments at over 14%. The cost of a typical apartment building and land in parts of Washington averages about $70 a square foot, though in some parts of the metropolitan areas it is higher. The rents required in a flat tax world, to cover costs and permit a competitive return on investment would be $1000 per month. The typical family earns $28,000 per year and will just be able to pay the $1000 a month or over a $1.00 a square a month for a typical 900 square foot apartment. The other half of the Nation's households will find housing unaffordable. Today, thanks to tax incentives and competition, rents throughout the country average at about 50 cents a square foot.

The tax code is complex, probably too complex, but the tax incentives were created for a very good reason -- namely that the Congress believed tax incentives would encourage certain types of investment that otherwise would go undone or would have to be heavlily subsidized through the appropriations process.

We are concerned that there is too much relevance on the proposition that the flat tax proposals are as advertised, really "revenue neutral" when in fact they are going to require in their place vast amount of federal spending to provide housing for a substantial minority of our population.

Finally, almost all of these flat tax proposals would discontinue the rapid amortization of low income housing. Low income housing is perceived by our members -- we believe correctly -- as involving greater risk, and what's more, greater aggravation, than other kinds of multi-family housing. Due to the dwindling direct cash subsidies from the government, if there were no incentives in the tax code, it is reasonably foreseeable that there will be very little low income housing constructed by the private sector. No business takes on more risk without the potential of increased reward.

To summarize our comments about these various forms of flat tax reform schemes, let me first say that we believe the Congress should do its homework. You must assess what the impact of these changes will be on capital formation in the industry, on the nation's housing stock, and on the availability of affordable housing for our citizens. We believe that the impact may not be in anyone's best interest.

VAT or NATIONAL SALES TAX

Turning to the various forms of national sales tax or value added tax proposals, we believe it is important to analyze these potential reforms from a similar viewpoint. Because there is no specific proposal for us to comment on, we must make our remarks general.

Some European laws either exempt basic human necessities such as food and costs of shelter (including energy costs), and other necessities from VAT, or tax these necessities at a lower rate.

Given our national housing policy, we believe this treatment would be appropriate for the United States as well.

However, if a VAT were to be placed on basic rental housing and not on homeownership, the impact on the rental industry would likely be very significant in limiting renters disposable income and their ability to afford rent without additional government assistance. If the VAT were applied to all shelter, it could also drastically change the cost of living for all Americans, but more severely to renters. Assuming a VAT was placed at the time of purchase of a home the VAT amount, would be considerable but would probably be placed in the mortgage. If placed on rents unlike the homeowners, a tenant's rent and VAT will go up with inflation. We also are concerned whether a VAT could effect the renting or buying decisions of Americans in ways that in the long run would be undesirable for our national priority for housing.

We are of course also concerned with the additional reporting requirements and paperwork that would be needed. Paperwork costs are a direct cost to business people and must be compared to the benefits of any VAT.

Finally, while taking no position either for or against a particular national sales tax or VAT, our members believe that the passage of this sort of tax is politically feasible. Our members are concerned, and we believe the American people are concerned with the continuing projections of box car size deficits rolling along as far as the eye can see. Some form of national sales tax or VAT could raise the revenue needed to rapidly reduce the deficit. However, like many of the other reforms being suggested, extensive analysis must be done on these proposals to ensure that the future welfare of the economy is not overshadowed by our over zealous political desires of providing quick-fixed solutions to problems that have been years in the making.

CONCLUSION

In conclusion, let me say that our members believe that getting the federal deficit back under control must be major priority for all of us. To that end, we look forward to continuing to work with you to assess various possible tax reforms and their likely effects on the incentives to capitol formation in the multi-family housing industry.

In light of our national goals and priorites of decent and affordable housing for every American person, we believe that such changes as recently publicized and as introduced into Congress would have major adverse impacts which may result in forseeable and at the same time unforeseable consequences for us all. Extensive and further analysis is needed before we can be sure that we have truly crafted a design to better serve the interest of all the American people.

Thank you very much Mr. Chairman for giving me this opportunity to testify before you today. I would be happy to answer any questions which you or other members of the Committee would have at this time.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. Mr. Jacobs, I want to make sure I understand. If we were to adopt Bradley-Gephardt, you are satisfied to have capital gains treated as ordinary income?

Mr. JACOBS. That's correct, sir. The capital gains tax would in effect go up to 30 percent.

Senator PACKWOOD. Yes. I would like to have Dr. Albertine comment on that.

Dr. ALBERTINE. Well, that's the one aspect of the bill that we would quarrel with, as Senator Bradley knows. For example, if you look at our cost of capital study, it turns out that double taxation of corporate income is terribly, terribly significant. We calculate, for example, that if you look at the cost of capital in the United States in 1983, it was about 16.5 percent. It fell from about 20 percent in 1982, largely because of the increase in equity prices in the equity markets. Our calculations show that if you went to a zero capital gains tax, it would knock off about five points on the cost of capital. So that is one aspect, as Senator Bradley knows, that we would quarrel with in his proposal.

Senator PACKWOOD. I want to ask your further judgment on something. On the last recess I toured some of the new high tech plants in Oregon—some of them 2, 3, 4 years old—most of them started by engineers from Hewlett-Packard or Intel or Tektronics. Almost to the man and woman, they indicated that the two most important things for them—and they had to have venture capital to start—were lowered capital gains taxes and stock options. Would you agree with that?

Dr. ALBERTINE. Yes, sir, absolutely, no question. Capital gains taxes help determine the cost of capital. The stock option is really a management tool which is terribly, terribly important to those firms.

Senator PACKWOOD. Well, one fellow who had come to be president of a company that had been founded only about a year ago left Tektronics and took a $3,000-a-week salary cut to move from managing a division of about 5,000 people to being president of a company of about 300 people, and he said he clearly wasn't going to do that in the hope that his salary would subsequently go up, but it was a very attractive stock option, and he hoped his management abilities would make this company go and the stocks would appreciate.

Dr. ALBERTINE. Yes, sir. That's a generic problem. The problem of those kinds of middle managers is the temptation to go off and start their own companies or to work for a larger company. It is terribly important to give them a stake in the company's future, and some stock options actually do that.

Senator PACKWOOD. Thank you.

No other questions, Mr. Chairman.

The CHAIRMAN. Senator Long?

Senator LONG. Mr. Albertine, you may have noticed the Barber Conable newspaper interview at the time he announced his retirement. He said that the complexities in the tax law result from a determined effort by Congress to do greater equity.

That is, the complicating provisions we have in the law really result from someone explaining a problem and saying, "Now, you see, this is not quite fair. I'm getting the worst of it compared to somebody else." And so the Congress would see it his way and pass a law. Then sometimes the Treasury would come back in and say, "Wait a minute, now. When you did that, you've got some people in that class who are getting too much of a break. So we've got to take some of it back." Bob Dole is great at that type of thing, by the way—"They're getting too damned much; we've got to take a little back." And I think he's got a good point.

Now, let's assume we just throw out everything in the Tax Code and start all over again. How long is it going to take before these deductions and these complexities begin to find their way back on in? And how many of the Members of Congress who voted for that type of thing are going to be able to tell their constituents "no" when they come back and say, "Here is this provision that has to do with me, and everybody agrees it's right; why shouldn't it be incorporated into the code?" How long do you think it will take for these things to find their way back into the code where they came from?

Dr. ALBERTINE. They would be in the next tax bill and right back in the code, Senator. I agree. [Laughter.]

I couldn't agree more.

I am very sympathetic to your point, Senator. You, of course, know everything there is to know about how people will come before you and plead special cases with respect to important economic problems.

Let's just take this dividend deductibility issue. The tradeoff we always have between simplicity and targeting relates to how much bang we get for the buck. If we, for example, were simply to eliminate dividends as a taxable item, the effect of that, we calculate, probably would be a $30 to $40 billion revenue loss to the Treasury. That's quite impossible.

On the other hand, if we were to eliminate dividend deductibility on new issues after some specified date, the revenue loss drops dramatically and perhaps makes it a do-able proposal. However, it introduces an additional complexity into the Tax Code.

And Senator, I think your point is extremely well taken. There has to be a balance, it seems to me, between simplicity and the need to do the things which are terribly important for the growth of our economy.

Senator LONG. Thank you.

Mr. Jacobs, I have looked at some of the proposals for a flat tax, and having been on this committee for more than 30 years I found myself saying, "Well, now, the first time somebody brings in an amendment to one of these flat-tax proposals that makes the first exception, that will be the end of it, because that one exception will lead to four or five more exceptions, and that will lead to another four or five exceptions, and after a while the Tax Code will go back to looking almost like it does now. And so after a great deal of working on the thing, we would have completed the circle, and would wind up back where we started from.

You came in here supporting the Bradley-Gephardt bill. You've got in that bill a deduction you are recommending—interest on a home mortgage. Now, that is not a business expense; that is an expense on housing, which is ordinarily regarded as being a living cost, the cost of providing shelter for you and your family.

If you are going to allow that deduction, you are not just a little bit pregnant, you are very substantially pregnant. [Laughter.]

How are you going to stop the other deductions from finding their way into the Tax Code all over again, once you allow that first one?

Mr. JACOBS. Well, it would be very presumptuous for me to comment on tax writing after your long experience, Senator Long, but I think my point is not any particular part of what new bills are going to do but that the present system is breaking down. And if in Bradley-Gephardt they try to deny the deduction on home interest, I wouldn't think it would have a very good chance of getting very far.

Senator LONG. Well, let's assume we try this approach. For the life of me, I don't see how we are going to keep these other deductions from finding their way back into the law step by step, such as in capital gains. Now, your proposal wouldn't have capital gains taxed differently, would it? There would be no capital gains in the proposal you advocate, right?

Mr. JACOBS. Yes, sir.

Senator LONG. All right. Let's say we enact that bill, and then a fellow comes up to us and says, "Now, look. I bought this piece of property 20 years ago, and if you adjust for inflation I haven't made 5 cents on the sale, in fact I've lost money. You are taxing me where I have lost money in real terms." How long do you think it will take the Congress to say, "Well, he shouldn't be taxed as ordinary income on that"? With regard to the Congress, how long can we defend that?

Mr. JACOBS. Well, the tradeoff, of course, is that people who are getting income are going to have their tax brackets go way down, from 50 to 30 percent.

Senator LONG. And all of those who have had experience in labor unions, who have enjoyed the benefit of these private pension plans, how long is it going to take before we give the deduction back for private pensions? How long?

Mr. JACOBS. I don't know.

The CHAIRMAN. One day. [Laughter.]

Senator LONG. I would hate to try to defend that position before the UAW at one of their meetings. I mean, it just seems to me that we had better recognize when we start somewhere what happens next, because that's where we so often get into trouble. We don't often look down the road and say "This is fine so far, but how do you keep the thing from coasting right on down the hill and over the cliff?" And I don't see how you are going to do that. You can start out with a flat tax, but how you are going to keep it flat, I for the life of me can't figure out.

Thank you.

The CHAIRMAN. Senator Symms?

Senator SYMMS. Thank you, Mr. Chairman.

Jack, would you want to comment on the fact that maybe the problem is that we tax the wrong things? I mean, we tax capital, and we tax work.

Dr. ALBERTINE. Yes, sir, absolutely.

You know, the fact of the matter is that this Congress, in conjunction with this administration, has made enormous progress, and I don't think you all get credit for the progress that has been made in this area. Reduction in the top marginal rate from 70 to 50 was terribly significant in terms of providing savings and work, and I think that is very important.

I think that is the precise issue. We have double taxation of corporate income, and I know that is essentially very popular politically. However, it turns out that corporate taxes are taxes on production. Our problem in this country is production. We need to shift, it seems to me, some of the tax burden away from production, savings, and investment, and onto consumption.

Senator **Symms**. Well, I got a newsletter from one of these fellows—I forget which one it was who sent me the letter—and he said what we need to do is to abolish the entire Tax Code as has been suggested by many of our colleagues here today and just put in a flat sales tax. And then he said every retail item in the country would carry two prices: One, what it cost, and it had a slash on it, and if you bought a suit it would be like $200/$100 for taxes, and take care of it, and given an exemption for the lower income people, and you would have it all solved. He makes it sound real simple. What do you think of that?

Dr. **Albertine**. That's a very intriguing idea, Senator.

The **Chairman**. You're about to retire from the Senate, I think. [Laughter.]

Senator **Symms**. You notice, I was careful to say I wasn't sponsoring it.

Dr. **Albertine**. It is easy for me to support it, Senator, since I'm not running for anything.

Senator **Symms**. I appreciate your comments.

Talking about simplifying the Tax Code, I wanted to ask Mr. Herder a question about something that just happened. Senator Quayle mentioned that our last tax bill had 1,300 pages. One of the main reasons for passing that bill was to help lower interest rates. Well, something happened in the bill, and thanks to the chairman it isn't quite as bad as it might have been. There is a little part in there where sellers get taxed on interest that they may never receive. There is a principle there that I find very concerning to me, that we tax people on income that they never earn. What is the impact of that on interest rates in the home market? In other words, imputed interest, in taxing people if they try to sell for below Treasury interest rates, seller-financed housing?

Mr. **Herder**. Well, I think one of the major areas where that would probably hurt is in multifamily housing. That would be a concern of ours.

Senator **Symms**. How does it affect interest rates?

Mr. **Herder**. It props them up—holds them up.

Senator **Symms**. In other words, the way the present Tax Code is, short of congressional repeal of this—now, Congressman Archer has introduced in the House, and I am introducing it in the Senate, the companion legislation to complete this section. But how will that affect the competitive interest rate structure?

Mr. **Herder**. Well, the repeal of that would be advantageous to interest rates.

Senator SYMMS. In other words, the way it will be now treated in the future is that if someone tried to sell a house for less than the prime interest rate, they would be paying taxes on it. So there is no incentive to sell and have seller-financed housing and drive interest rates down.

Mr. HERDER. That's right.

Senator SYMMS. Thank you very much.

Mr. Jacobs, you endorsed the Bradley-Gephardt proposal. Do you view the other proposals—we've got several here. I had a list of them here before me. Oh, we've got the FAIR proposal with Bradley-Gephardt, the FAST proposal with Kemp-Kasten, the Self proposal with Quayle. Have you looked at all of those?

Mr. JACOBS. The only one I am thoroughly familiar with, sir, is Bradley-Gephardt. But I would say that I believe the others don't have a progressive feature in them.

Senator SYMMS. I think the Quayle plan does—Self.

Mr. JACOBS. OK. I'm not familiar with that. But as I said in my written testimony, this bill maintains progressivity in our tax system. It redistributes income for citizens within defined classes, and I personally believe that the type of system of progressivity is favored by the majority of voters are being more fair than others.

Senator SYMMS. Do you think we should go one step further and have a negative income tax, so we didn't have to have HHS down here, too?

Mr. JACOBS. No.

Senator SYMMS. You do not. All right.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bradley?

Senator BRADLEY. Thank you very much, Mr. Chairman. Mr. Jacobs, I like your testimony. [Laughter.]

Let me ask you one question about the interaction between equity financing and debt financing in an atmosphere where you are lowering tax rates. Right now a lot of financing for corporations is done out of debt financing. Do you see a system where you get a much lower tax rate as having any impact on where corporations go to get their capital?

Mr. JACOBS. I hope I give you the right answer after that nice question.

If investors are going to be taxed at a lower rate, then I would think there would be more of a desire to buy common stocks and less of a desire to invest in tax gimmicks such as tax shelters.

I think that a program like this could possibly result in a more favorable equity market, a broader market, and a higher price for stocks. If you get a higher level for common stocks, then companies are going to do more equity financing than debt financing, and I think it could result in an improved equity-versus-debt relationship on corporations' balance sheets.

Senator BRADLEY. So you see dropping the marginal rate as a promotion of an increase in financing through equity markets?

Mr. JACOBS. Yes. I also think, even though small and fast-growing companies would lose the advantage of capital gains, they would gain the advantage of a 30-percent rate than perhaps a 46-percent rate, which most profitable high tech companies find themselves in very quickly.

Senator **Bradley**. So, the example that Senator Packwood gave when he toured his high tech companies and they said the thing they liked was lower capital gains and stock options was essentially what they liked in a world of very high marginal tax rates, in which many of those companies pay over 40 percent in tax?

Mr. **Jacobs**. That is correct.

Senator **Bradley**. So, if you lowered the rate, there would be less of a need for the particular provisions that they benefit from now, and should benefit from, given the high marginal rate. Is that correct?

Mr. **Jacobs**. That's my belief.

Senator **Bradley**. Dr. Albertine, let me ask you a question, simply because we had a witness in our last panel who made the point that if you are going to tax investment income, and you want to stimulate investment and savings, and if you are not going to have a zero rate of tax on investment and savings, which would also mean a zero rate on interest and dividends—then you ought to treat all income the same. And if you don't treat all income the same you then get into the situation that we have now where some investment income is taxed at zero, other investment income is taxed at 20 percent, and still other investment income is taxed at 50 percent. The result of these different rates is misallocation of resources and inefficiency.

Do you agree with the economist who was here from the University of Pennsylvania, Marshall Blume, who testified in our last panel that we should either have no tax on investment and savings, or treat all income the same, but not try and cook up so-called savings incentives?

Dr. **Albertine**. Yes, Senator. You put the problem correctly, as usual.

There are two issues. One has to do with the percentage of total gross national product which would go to the investment sector. The second is the skewing relative rates of return on investment capital.

In general terms, the Tax Code ought to be as neutral as possible. However, there is also an issue, that relates to the percentage of total gross national product that goes to the investment sector. To the extent to which you have high marginal corporate rates, if they are neutral across asset categories, that is beneficial with respect to the issue of skewing relative rates of return, but it is not beneficial with respect to the issue of total GNP which goes to the productive sector.

Senator **Bradley**. Let me ask each of the panelists a question, and just answer yes or no.

Do you believe that the biggest tax stimulus to investment and savings is the lowest possible tax rate on profit?

Mr. **Slesinger**. I think that encourages investment, yes.

Mr. **Herder**. Yes.

Mr. **Jacobs**. Yes.

Dr. **Albertine**. Yes, sir.

Senator **Bradley**. Thank you.

The **Chairman**. This is like the McLaughlin Group. [Laughter.] Senator Roth.

Senator Roth. There has been considerable debate about incentives for savings, as to whether or not our Tax Code affects people's economic decisions. And I would like to ask that as my first question: Do you think the way we structure our Tax Code affects people's economic decisions? I would ask you, if I could, to be as brief as possible.

Dr. Albertine.

Dr. Albertine. No question, Senator, absolutely.

Senator Roth. Mr Jacobs?

Mr. Jacobs. Absolutely.

Senator Roth. Mr. Herder?

Mr. Herder. Yes, sir.

Senator Roth. Mr Slesinger.

Mr. Slesinger. Very much, tacked to consideration.

Senator Roth. Do you think that the way we treat savings under the Tax Code in any affects how much people save?

Dr. Albertine. Yes, sir, and we have been penalizing it, and a reduction in the marginal rate from 70 to 50 was helpful in that regard.

Senator Roth. Mr. Jacobs.

Mr. Jacobs. Well, what we are doing in savings is somehow not competitive with countries like Japan and Germany where you have a much higher percentage of the GNP going into savings than we do, and it's something we've got to rethink.

Senator Roth. Thank you.

Mr. Herder.

Mr. Herder. Well, we'd like an individual housing account, much like an IRA, so I think we would like to see additional savings.

Senator Roth. Mr. Slesinger.

Mr. Slesinger. I think we have to be careful that if we encourage too much savings, industry won't have the incentive to do the investments. For instance, if a lot of people are saving money and not buying GM cars, GM is not going to build a new plant. So I think we have to have an equilibrium that encourages savings and consumption. Unlike Japan, we cannot sell most of our goods overseas; we sell it to our own people. If they are saving and not spending, we may have trouble doing that.

Senator Roth. Well, of course I am one of the people who think that we have to look for greater exports. If the great growth market is going to be out in the Pacific Basin and elsewhere, we had better become competitive.

Mr. Slesinger. Mr. Herder and I have a problem that our products do not travel very well. [Laughter.]

Senator Roth. Would it not be desirable, along with Mr. Herder said in answer to my question, to have some kind of a super-saver for the average individual? We took a step that way toward an IRA, but really provide some major tax incentives to get the typical American to save, not only for retirement, but as you say for houses or for whatever use. Do you see this being useful in the capital formation?

Dr. Albertine. Yes, sir, Senator, I certainly do. I would support almost anything, frankly, to increase our savings rate.

To get back to this point, I think we have to remember that aggregate demand has components, and one component of demand in the economy is the demand for capital goods itself, as well as for other vehicles of investment. So I don't worry about the fact that our savings rate is too high—our savings rate is so low. We could increase it significantly without having any——

Senator ROTH. It would be nice to have that problem, wouldn't it?

Dr. ALBERTINE. Yes, it would. It would be nice to have more demand for capital goods in the economy, frankly.

Senator ROTH. Mr. Jacobs.

Mr. JACOBS. I think if the tax brackets go down and the inflation is moderate, that savings will go up, sir.

Senator ROTH. I agree with you, and that was the theory of Roth-Kemp. But would it not, at the same time, be desirable to try to build some additional incentives to get people to save?

Mr. JACOBS. Well, I think any kind of innovative device like a super-saver is always constructive, just like the lowering of the capital gains rate was constructive. But I think that what we are faced with, as I said in my opening, is that we've got so many things going on that the people out there are gradually losing faith in the whole ball of wax, and that's why what all of you are doing is a very constructive thing and very timely.

Senator ROTH. I would like to come back to that point, but first I would like to get Mr. Herder's answer to my question

Mr. HERDER. Well, I touched on it when I talked about the individual housing account. Our primary concern is with the first-time home buyer, that couple who is going to reach age 30 in the decade of the eighties. Eighty percent of them out there can't afford to buy a home. And what we can do to help them get into housing is one of our primary concerns. That's why we have talked about an individual housing account, especially related to the first-time home buyer.

Senator ROTH. Mr. Slesinger.

Mr. SLESINGER. I think for high-income individuals it's clearly a lower tax bracket, because they probably will spend what they were going to spend anyway. It would encourage them to save or invest a larger percentage of their income.

Senator ROTH. I would like to ask a couple of more questions.

I would like to go back to the point that Senator Long makes, because I think it is a very troublesome one and one that has great merit. Isn't it true, at the same time, that even over a period of time we may find ourselves going down the same road, that by lowering the marginal rates you are not going to have the same pressures for all the tax deductions and credits that we have when you have very high marginal rates? Wasn't that an effort to avoid those high marginal rates, and didn't that give great impetus so that while it may not cure the problem indefinitely by simplifying it—and I think the encouraging thing right now, Mr. Jacobs, and I urge you to look at the number of good proposals, bipartisan, using the same approach.

The only place I disagree with most of their approaches is, I think we should build some additional incentives to save. I think that, as we look at our tax reform, the thing bothers me is that so often we say here in the committee, "Well, how much revenue does that mean?" or "How much did we lose?" Shouldn't an equally important factor be "How much will this help a long-term economic growth?" And for that reason, I think we ought to go one step further than these other proposals in having some kind of a supersaver as a basic element of capital formation for the long-term growth and job formation in this country. Would you agree, Mr. Jacobs?

Mr. JACOBS. Well, I think that that certainly is a thoughtful approach which should be considered as you go forward in your studies.

Senator ROTH. Thank you.

Dr. ALBERTINE. Senator, I have two very important points. One, the way to simplify the Tax Code, get rid of exemptions, exclusions, and deductions, is to lower marginal rates. I think that is the most effective way to do it.

Second, if you look at the Japanese model, for example, the Japanese have a huge deficit as a percentage of GNP. It systematically and historically is larger than ours. They are able to finance that because they have such a high savings rate.

The savings rate is a key variable to future economic growth in our country.

Senator ROTH. Thank you.

Mr. Herder.

Mr. HERDER. Well, I would like to reiterate that housing policy basically is being shaped by tax policy. What you say is very interesting. If it creates more savings, again it is related to that first-time buyer; we have a strong interest in that.

Senator ROTH. Mr. Slesinger.

Mr. SLESINGER. I think that, as you said, once we start going down that road from a perfect simplified tax system, it goes on forever, because all these incentives were put there for a reason—to make our industry viable, to make home ownership the American dream. And I think if you start to put exemptions in there, we are going to come around to what Senator Long said, a system just about like we have now

Senator ROTH. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Should we move to a consumption tax? Should a consumption tax be in addition to a Federal income tax or in place of a Federal income tax? And would a consumption tax encourage savings?

Dr. ALBERTINE. Senator, speaking for the American Business Conference, our position for some time has been that that is exactly what we ought to do—move toward taxing consumption rather than savings and investments.

As a practical matter, it seems to us that it doesn't seem likely in the near future that a consumption tax would replace the entire income tax system. Certainly, it is terribly important that we move in that direction, when we collect the additional revenue which is owed to the Federal Government, and not now paid to the Federal Government.

It is also very important with respect to lowering marginal tax rates, both on the personal and corporate side.

Senator DANFORTH. Mr. Jacobs.

Mr. JACOBS. I don't think that we ever can move completely away from a progressive system of taxation in our country, although under Bradley-Gephardt it is lowered. And I think that any type of new tax system such as you are studying is going to take some time.

The deficit problem in this country is so overwhelming that it could well be that in 1985 you will have to put in some type of temporary consumption tax just to patch the terrible deficit.

Senator DANFORTH. But only temporarily.

Mr. JACOBS. I would hope so.

Senator DANFORTH. And only for the sake of raising revenue, not for the sake of encouraging savings or for the sake of redressing the trade deficit.

Mr. JACOBS. Only for the sake of patching the terrible deficit.

Senator DANFORTH. Mr. Herder.

Mr. HERDER. All I can say, Senator, is that our association, our industry, is taking a look at it. We are studying it.

Mr. SLESINGER. We are concerned that the consumption tax would be retroactive and hit our residents quite strongly, because most of them spend the highest percentage of their income on consumed goods than any other category of income groups. If you have to start putting exemptions for necessities, the consumption tax can also get quite complicated.

Senator DANFORTH. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. Dr. Albertine, let me ask you another question. On page 5 of your statement you say, "Most U.S. corporations have a debt-to-equity ratio of 1-to-3, while for most Japanese firms it is 3-to-1."

Dr. ALBERTINE. Yes, sir.

Senator PACKWOOD. Do you mean by that that most Japanese firms, when they expand or finance themselves, do it by borrowing, and most U.S. firms do it by the sale of stock?

Dr. ALBERTINE. Exactly, Senator. Most Japanese industrial corporations, in fact all publicly held Japanese corporations, are owned by financial institutions. The distinction between debt and equity in Japan really breaks down.

For about three-quarters of their capital resources it turns out that returns are tax deductible.

Senator PACKWOOD. I thought that was the answer, and the reason I wanted to ask—and this is just a theory; I've got no substantive evidence on this, so you tell me if the theory is even possibly right—historically, in James Clavell's "Noble House" which is set in Hong Kong in 1862, and the major trading company is a privately held trading company. And one of the debates in the book is about going public with the trading company. And it is almost immoral, that this ought to be financed out of personal wealth or borrowing from friends, but you should not go "public."

Dr. ALBERTINE. Right.

Senator PACKWOOD. That historically in Asia, to a lesser degree in Europe and certainly to a lesser degree here, capital expansion has been financed out of savings in Asia and out of equity in the United States, and with Europe, some place in between.

Dr. ALBERTINE. It is clearly true in Japan, and I think you have put the problem correctly—it is about in between in Europe.

Senator PACKWOOD. And the capital-stock corporation has really been the genius of American growth. And I think we try to fly in the face of this tradition if we try to increase savings for the sake of increasing savings rather than looking at the expansion of incentives to develop in the way that has been our traditional way of expanding.

Dr. ALBERTINE. Yes.

Senator PACKWOOD. I have no objection to increasing savings; I think it is probably more positive than negative, but I don't worry per se about our low savings rate. We never got over 8.5 percent in the history of this country, and we were roughly at 7.5 during the fifties and sixties. And we expanded to beat heck.

Dr. ALBERTINE. I guess there is a terminology problem here, Senator. First, I would regard savings as any nonconsumption; whether or not it is debt or equity, to me it is savings.

But with respect to the issue you have raised, it is an excellent one. We are not interested in changing the financial structure of the United States. The fact of the matter is that our equity markets give us enormous benefits, in terms of start-up of new corporations, in terms of incentives for people to innovate. Our equity market is one of the most important parts of our economy. We would not change, for example, the regulatory environment in this area.

But, we do think it is important to look at the question of double taxation of corporate income. One of the major reasons why equity is so much more expensive than debt is that dividends are not deductible and interest payments are.

Senator PACKWOOD. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Mr. Chairman, may I ask one last question?

The CHAIRMAN. One more. We have 16 more witnesses.

Senator BRADLEY. This is to Dr. Albertine, quickly: Do you contend that there is any evidence of a relationship between the overall savings rate and tax incentives?

Dr. ALBERTINE. Yes, sir.

Senator BRADLEY. As opposed to simply shifting available savings among different savings instruments?

Dr. ALBERTINE. No. No, Senator.

Senator BRADLEY. And could you cite that evidence?

Dr. ALBERTINE. Yes, sir.

There is, of course, a great debate, and there probably always will be in the economics profession on this issue. My personal view is that life is fairly simple. The amount that individuals will consume depends on the rate of return on savings—all savings instruments, debt as well as equity. The higher the rate of return on savings, the greater proportion of total gross national product will go into those instruments.

If that's not true, then we understand very little about the economic environment and the physical environment. And if that's not true, it means that if I went to the top of this building and jumped off, there would be some probability I would go up and not down. And we generally can predict that I will fall. But if what I said is not true, then the probability that I would go up is probably 0.5.

Senator BRADLEY. Or point – 4. [Laughter.]

But you did agree that the best tax incentive for savings and investment is the lowest possible tax rate on profits.

Dr. ALBERTINE. Well, Senator, as usual you make a very good point; the issue is the relative rate of return on investment capital. One component of that is taxation. There are other components of that as well.

The issue really is the relative rate of return on one activity versus another activity—consumption versus savings.

The CHAIRMAN. Well, I want to thank the members of this first panel. I have been looking over this Tax Notes of June 4, which you ought to take a look at if you haven't studied all of these different proposals. It's a pretty good little volume here. It tells what will change. And I am not certain. I have never been able to determine who had the most powerful lobbying organization, but when I look down at all of these things that "are going to be repealed," I've got a feeling that some might sneak back in—as Senator Long indicated. And I know the homebuilders, in essence, said "you don't really care if you have a flat tax or raise revenue, so long as you are not touched." And you know, I think that is probably a fair statement. Everybody feels the same way. "As long as we are excluded, we're for it. We want to simplify the code and do all of those good things, but don't ask us to do anything"—take it out of food stamps, or some other program.

I think it is interesting. I have looked over some of these things I had even forgotten we had in the Tax Code—maybe we ought to take a look at those. [Laughter.]

But a lot of these things are going to be repealed in any of these so-called flat, FAIR, FAST, and other type taxes. And a lot of things other than mortgage interest that affect the housing industry are going to be repealed, modified, altered.

My own view is, I'm not advocating or denouncing any of the plans; but I think we do need to have extensive hearings so we don't surprise anyone. So we will probably be back here again.

We appreciate very much your coming. And I am pleased that we have people advocating that we not have a surtax. I can't think of a more unfair tax than a surtax, for some. For those who don't pay any taxes, it's a great idea. And they'll all be for it.

I would assume most of your people, Dr. Albertine are in about the 30 percent effective rate?

Dr. ALBERTINE. Yes, sir.

The CHAIRMAN. Does anyone else here like surtaxes?

Mr. HERDER. No.

The CHAIRMAN. Do you like taxes at all? [Laughter.]

Mr. JACOBS. I don't know if I'm for a surtax or not. I know I am for reducing the deficit, or I think we are going to have major, major problems.

The CHAIRMAN. That leads into another area we probably shouldn't get into—I mean, there have been so many people into it now. It's on taxes, no taxes, and all of that.

But we do appreciate your coming, and we will be in touch. We will have additional hearings in September, and then I assume there will be hearings after November.

Dr. ALBERTINE. Thank you.

Mr. JACOBS. Thank you, sir.

The CHAIRMAN. Our next panel: Rudy Oswald, director of the American Federation of Labor; John C. Lynch, legislative counsel, Citizen's Choice; Howard Phillips, national director, the Conservative Caucus; Jim Jones, managing director, Government Research and Development Foundation.

That's quite a group.

Rudy, I think you are first.

I would say again to this group, your entire statements will be made a part of the record. We are hoping that you can literally and briefly summarize your statements, because we have had a pretty good exchange from members with the witnesses, and I think that is more helpful.

STATEMENT BY RUDY OSWALD, DIRECTOR, THE AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS [AFL-CIO], WASHINGTON, DC

Mr. OSWALD. Senator, I thank you for the opportunity to present the views of the AFL-CIO on this issue. I believe that you particularly and the committee as a whole are to be commended in holding these hearings on this very important subject that we think is central to the problems that the country faces today.

If I could summarize what my more lengthy statement has, first of all we believe that the high budget deficits need to be corrected, and a major element in that correction must be an increase in Federal revenues.

Second, the tax system already is riddled with loopholes, has been for many years, and the 1981 Tax Act made it even worse. It made the direction of the loopholes one that particularly favored the rich, and reduced the corporate income tax as a contributor to paying for the American budget.

Third, that fairness needs to be restored to the tax system. We believe that this can best be done by closing many of the tax loopholes, and those particularly that have been widened so dramatically recently in terms of favoring business and the wealthy.

In terms of the proposals that you have indicated—flat tax systems, value-added taxes, sales taxes, consumption taxes—they are all, in our view, unfair tax systems. They primarily benefit the wealthy, and in terms of the standards that you yourself have indicated in the committee report are not based upon ability to pay.

On these bases, we believe that these proposals should be rejected.

On the other hand, the AFL-CIO does support major tax reform initiatives that would close loopholes, that would reverse some of the more unfair and unwise features of the 1981 law, as this committee has already done in some of its reconsideration of that law in 1982 and 1984.

We believe that the primary principle is that the income should be the basic element of tax receipts, and that it must retain a progressive rate structure.

Our specific proposals in this respect are spelled out from page 22 on in our testimony, and we believe that it is time that Congress move forward, as soon as possible in the next session, to enact a comprehensive tax reform program based on these principles, to enhance equity, cut the deficit, and by doing that would improve the underlying structure of the Nation's economy.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Howard.

[Mr. Oswald's written testimony follows:]

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Testimony of Rudy Oswald, Economic Research Department,
American Federation of Labor and Congress of Industrial Organizations
on the Major Tax Reform Options
Before the Senate Finance Committee
August 9, 1984

Summary of Principal Points

The AFL-CIO's position on the issue of major tax reform can be summarized as follows:

* The high budget deficits need to be corrected, and a major element in that correction must be an increase in federal revenues.

* The tax system -- already riddled with loopholes -- was severely distorted in favor of the rich and business by the 1981 Tax Act.

* Fairness needs to be restored to the tax system. This can best be done by closing many of the tax loopholes favoring business and the wealthy.

* Flat tax systems, value added taxes, sales taxes, and consumption taxes are all unfair tax systems -- as they primarily benefit the wealthy and are not based upon ability to pay. These systems should be rejected.

* The AFL-CIO supports a major tax reform initiative that would close loopholes that favor business and the rich, reverse some of the more unfair and unwise features of the 1981 law, keep income as the tax base, and retain a progressive rate structure.

A comprehensive tax reform program based on these principles will enhance equity, cut the deficit, and improve the underlying structure of the nation's economy.

Testimony of Rudy Oswald, Economic Research Department,
American Federation of Labor and Congress of Industrial Organizations
on the Major Tax Reform Options
Before the Senate Finance Committee
August 9, 1984

The AFL-CIO would like to commend Chairman Dole and the Finance Committee for holding these hearings on major tax reform options and recognizing that this nation must raise revenues in order to reduce the massive deficits that threaten the nation's economic future.

The Tax Code, Deficits and the Economy

The AFL-CIO's position on the issues now being addressed by this commmittee can be summarized as follows:

* The high budget deficits need to be corrected, and a major element in that correction must be an increase in federal revenues.

* The tax system -- already riddled with loopholes -- was severely distorted in favor of the rich and business by the 1981 Tax Act.

* Fairness needs to be restored to the tax system. This can best be done by closing many of the tax loopholes favoring business and the wealthy.

* Flat tax systems, value added taxes, sales taxes, and consumption taxes are all unfair tax systems -- as they primarily benefit the wealthy and are not based upon ability to pay. These systems should be rejected.

* The AFL-CIO supports a major tax reform initiative that would close loopholes that favor business and the rich, reverse some of the more unfair and unwise features of the 1981 law, keep income as the tax base, and retain a progressive rate structure.

We are very concerned with the condition of the nation's tax system. It cannot raise enough revenues to finance even the minimal level of government programs that the public has indicated it wants. The massive revenue shortfall has grave implications for the nation's economic future. Both loopholes and the Tax Act of 1981 have significantly contributed to the tax structure's deviation from the standard of fairness based on ability to pay.

At first glance, with entitlement outlays amounting to $408.2 billion (44% of total outlays), it would appear that some deficit reduction could be achieved in this area. But upon closer examination of the nature and financing of these programs, this proves to be incorrect.

Social security, unemployment compensation, medicare, civil service retirement, and railroad retirement; make up $325.3 billion, or 80% of entitlement outlays. These five programs make up 35.2% of total outlays of the federal government and are primarily financed through trust funds and separately collected and earmarked taxes/contributions. For the most part these trust funds tend to be in balance or surplus (See Table I in the appendix).

The combined budget estimates for 1985 project outlays of $325.3 billion, and receipts of $352.9 for these funds. The total surplus of these funds in 1985 is thus estimated to be $27.6 billion.

This nation is posting historically high federal budget deficits which will persist for many years if the tax code is not reformed. These deficits stem from the deep recession during 1981 and 1982 and its aftermath, the rapid defense buildup, the massive and inequitable tax giveaways of the Economic Recovery Tax Act of 1981, and the billions of dollars that are lost through the many loopholes in the tax structure.

The economy is finally recovering from the worst economic decline since the Great Depression of the Thirties. The recovery's initial strength was a reflection of the tremendous federal deficit, which has provided huge increases in both business profits and personal income, particularly for large corporations and the well-to-do.

If continued strong growth is assumed, the Treasury will still incur large "structural" deficits under current tax law. However, the recovery itself may be fragile and give way to another severe recession.

These huge deficits, which result, in large measure from the tax cuts of 1981 and the excessive revenue lost through tax loopholes, place a tremendous burden on future generations, and borrow from future economic growth and wellbeing. As a result of the revenue shortfall, interest rates have moved to their highest nominal levels in two years, and the highest in real terms in this century. The upward momentum of interest rates will probably curtail demand and cause a recession.

The overvaluation of the foreign exchange value of the U.S. dollar is another damaging product of these mounting federal deficits. High U.S. interest rates, especially when viewed in "real" terms by adjusting for inflation, have resulted in a steep rise in the demand for dollars in foreign exchange markets as buyers seek to earn these high returns on dollar denominated assets. The overvalued dollar makes U.S. products more expensive abroad and foreign products cheaper in the United States, and has caused a precipitous drop in the nation's manufacturing trade balance. The nation's trade deficit is likely to reach at least $120 billion this year, compared to about $30 billion in 1981. Millions of jobs and job opportunities, especially in the nation's important industrial sectors, are being lost, and much of this loss can be attributed to the results of the tax follies of 1981.

Thus, the nation's economy -- although currently recovering from the deep 1981-1982 recession -- is exhibiting the preliminary effects of the structural weakness and imbalances resulting from the highest federal deficits in history. The nation's tax system must be restored as a productive source of revenues to correct those negative pressures.

Taxes, Savings, and Investment

The proponents of gaping tax loopholes and the large tax reductions for the rich and the corporate sector which were enacted in 1981 argued that these gimmicks promote savings and investment, and thus enhance economic efficiency.

The predicted rise in savings and investment did not occur. The initial response to the 1981 law, for example, was a steep drop in business investment which extended for two years. Real business investment remained below its value of the third quarter of 1981 until the last quarter of 1983. Similarly, the personal savings rate, which has been lamented as insufficient to provide adequate funds for capital formation, dropped to 4.8 percent last year, which is the lowest annual savings rate since 1949. While it has crept above 6 percent during the first half of this year, the savings rate remains significantly below the 7.3 percent average of the 1970's.

But, this emphasis on personal savings has been overdone. Personal savings makes up less than one-fourth of gross private savings. Business savings far outweighs personal savings as a source of funds for investment. Further, business savings often tend to rise when personal savings drop. When consumption rises as a portion of personal income, which is mirrored as a decline in the savings rate, business sales increase. The resulting rise in business profits permits an increase in business savings.

In addition, a one dollar increase in the federal deficit represents a one dollar subtraction from total national savings. So the result of a one dollar tax reduction designed to stimulate savings is an immediate one dollar reduction in national savings, but the recipient of that dollar in the private sector will not save all of it. Part of it will be spent. Because the rise in the federal deficit will exceed the rise in private savings, tax-based savings-incentives will typically reduce, rather than increase, total national savings.

Furthermore, from a theoretical standpoint, it isn't even clear that a rise in the after tax rate of return to saving, which results from a tax reduction, will stimulate an increase in savings. A higher return does make savings more attractive. At the same time, however, a higher yield makes it easier to reach one's savings goal, and it gives an individual more money to spend. For example, if an individual saves in order to accumulate a particular sum for retirement, that sum can be reached by saving less if the rate of return is higher.

The importance of savings and investment and their role in economic growth is greatly overstated by the proponents of tax-based savings and investment incentives. Personal savings, for example, is not the principle factor determining business investment. In addition, investment itself is not the most important source of growth. Instead labor and labor-related factors, such as improvements in health, worker's skills, and the advance of knowledge, explain a far higher share of economic growth than does capital. And, the trend in investment as a share of GNP was higher during the 1970's than during the 1960's when the rate of economic growth was higher.

Examples of savings promotion tax gimmicks introduced by the 1981 Tax Law include the All Savers Certificate and the expansion of Individual Retirement Accounts. While considerable funds were placed in such accounts to achieve their accompanying tax benefits, most were simply shifted from accounts which were not similarly favored by the tax code. A recent study by the Life Insurance Marketing Research Association found that in 1982 only 11 percent of IRA investments were entirely new funds (Business Week, Aug. 6, 1984.) The private savings rate actually fell, while these and other tax cuts added more red ink to the federal budget, and the total national savings rate dropped.

Such tax-based savings gimmicks are also extremely unfair because individuals with high incomes get greater tax reductions. For someone in the 50 percent bracket, for example, $2,000 deposited in an IRA generates a $1,000 tax reduction. In contrast, an individual in the 20 percent bracket gets only $400 for a $2,000 IRA deposit.

On the investment side of the equation, the decline in the quarterly volume of real business investment for two years in a row, after the enactment of the huge corporate tax reductions included in the 1981 tax law illustrates the ineffectiveness of tax cuts in promoting investment. The 1981 tax law established the accelerated cost recovery system (ACRS) which consolidated depreciable assets into a few categories with amortization schedules that had no meaningful relationship to the actual useful lives of the assets.

One ostensible purpose of the ACRS provisions was to offset the effect of inflation on replacement costs. But, the new ACRS categories are totally unrelated to the rate of inflation. In addition, to the extent that investment is financed through borrowing, inflation reduces the real debt burden. Thus, the effect of inflation on the liability side of the corporate balance sheet offsets its effect on the asset side.

Under the ACRS provisions, the disparity between effective tax rates on business equipment in different industries was increased considerably. Industries with a higher share of equipment in their total investment received far greater benefits. After ACRS was introduced, effective tax rates varied from a low of negative 11 percent in the motor vehicle industry to a high of 37 percent in the services and trade sector. Thus, the 1981 tax law terribly distorted the effect of taxes on rates of return on investment.

In addition to the ACRS provisions, corporations were also favored in 1981 by a liberalization in the investment tax credit. But the initial introduction of the investment tax credit in the early 1960's didn't raise business capital investment's share of gross national product. In general, investment has tended to increase during periods in which the general economy is on the ascent, not as a result of favorable tax treatment.

The 1981 tax law, in addition to liberalizing the investment tax credit and instituting the excessively generous ACRS provisions, also established safe harbor leasing and gave birth to a whole new industry involved in the exchange of tax benefits. These exchanges arose because many firms had tax preferences associated with investments that exceeded their taxable profits. In some instances these excess preferences occured because the firms were unprofitable. In many cases, however, profits had been erased by tax benefits. Safe harbor leasing allowed corporations to sell depreciation deductions and investment tax credits resulting from particular investments to other companies that could make use of them. The firm purchasing the tax benefits would then lease back the plant or equipment to the selling firm, and share part of the tax benefit in the form of reduced leasing costs. The 1982 Tax Law took the positive step of phasing out safe-harbor leasing.

Other changes in the 1981 tax law that reduced taxes on capital included the reduction in the top rate of taxation on capital gains from 28 to 20 percent. Now, the newly-enacted 1984 tax law has reduced the capital gains holding period from one year to six months. The ostensible purpose of these changes is to prevent the so-called lock-in effect, in which high tax rates on capital gains purportedly make capital owners less willing to sell their assets and pay capital gains taxes. But such tax loopholes and the resultant narrowing of the tax base in themselves have caused the higher tax rates which supposedly produce the lock-in effect. Such loopholes should be closed, not made even wider.

Further, the capital gains gimmick is distinctly unfair because only the well-to-do can afford to take advantage of it. And, like other loopholes, the effectiveness of reduced taxation on capital gains in promoting productive investment is highly suspect. Many purely speculative assets are eligible, including oriental rugs, artwork, and jewels; and, a major share of the financial transactions benefitting from the capital gains loophole is in existing rather than new assets.

The strength of investment during the 1970's illustrates that there was no need virtually to eliminate the corporate income tax in 1981, or, for practical purposes, to exempt capital and the rich from taxation in order to promote investment. During the 1970's, for example, the ratio of investment to GNP averaged 10.5%, while this ratio averaged 9.8% during the 1960's. Thus, it wasn't necessary to shift the economy towards investment through tax giveaways to the owners of capital.

The end result of all of these tax gimmicks, both corporate and personal, is a decimated tax code that fails to raise sufficient revenues and results in huge federal deficits, high interest rates, an overvalued dollar, a mounting trade deficit, an economy whose basic foundations are being undermined, and a complete departure from fairness as the guiding principle of taxation.

Taxes and Equity

Tax loopholes and the 1981 revenue giveaways have moved the tax structure further away from any reasonable standard of fairness. Increasingly, those with the greatest ability to pay are paying less than their fair share.

Before 1981 the tax system included many unfair elements, but the legacy of the 1981 law is a panoply of even greater inequities.

Over the period from 1982 through 1984, the 5-10-10 percent individual income tax cut introduced distortions which have lavished vast and unfair cumulative benefits on the wealthy. During this three-year period, a family of four at $20,000 receives only $1,063, while a family at $100,000 gets a cut of $12,607. Thus, the family with five times the income obtains nearly 12 times the tax cut. (See the attached chart illustrating the distribution of the third year tax cuts.)

The 1981 law's business cuts have also contributed to the great decline in fairness. In 1984, corporations will pay only about 9.6 percent of total anticipated federal tax receipts. In contrast, corporations paid 12.5 percent of total federal receipts in 1980. In 1970 the corporate share of total revenues was 17 percent, and in 1960 -- before the enactment of the investment tax credits, rate reductions, and depreciation speedups of the sixties --corporations financed nearly 25 percent of the entire federal budget. If the corporate income tax share in 1984 were only as high as in 1980, federal receipts would be $20 billion higher.

Within the business sector itself, the ACRS provisions have generated huge distortions. Large firms benefit much more than small firms, because small firms are typically not as capital intensive. Even firms with the same degree of capital intensity are taxed at widely disparate rates, based on the type of capital in which they invest. Thus, the ACRS system is neither efficient nor equitable, and it has contributed significantly to the massive revenue shortfall and the resultant weaknesses that will undermine the economy's future.

The Tax Laws of 1982 and 1984

In 1982, and again in 1984, Congress, embarrassed by the many abuses stemming from the Tax Act of 1981, and by the dramatic revenue shortfall, pushed through a set of tax changes to constrain some of the more egregious tax giveaways and restore a portion of the revenues lost as a rsult of the 1981 law.

The 1982 Tax Law phased out the safe harbor leasing provision which permitted individuals and corporations to buy and sell tax write-offs. It also strengthened the minimum tax provision so that those with large amounts of tax sheltered income contribute more equitably to the nation's revenue needs. The 1982 Act also belately extended the principle of payroll withholding to recipients of interest and dividends. Because banks mounted a massive and unprecedented lobbying campaign, however, Congress reversed this much needed improvement.

The 1982 Act restored about one-third of the revenues lost in the 1981 tax giveaway and changed some of the unfair provisions put in place in 1981. Nonetheless, most of the revenue lost because of the 1981 law was not recovered, and the tax structure remained far less equitable than it was before.

In the recently enacted Tax Law of 1984, Congress has again implemented several useful measures to raise revenues and eliminate some abuses. These include the phase-out of the benefits of graduated corporate tax rates for large corporations; caps on the use of tax-exempt industrial development and student loan bonds; a reduction in tax benefits for luxury cars used for business; a twenty percent excise tax on excessive "golden parachutes" for executives whose positions are affected by takeovers; a cutback in depreciation deductions for real estate; and revisions intended to reduce tax shelter abuses.

But the 1984 law leaves intact an extensive array of unfair tax loopholes, and doesn't come close to raising enough revenue to reduce the deficit to an acceptable range.

In addition, the 1984 law introduces many provisions that jeopardize worker's hard-won gains. Fringe benefits are unfairly singled out as a source of tax revenues, while the many benefits favoring corporations and the rich are not subject to similar treatment. The deductibility of educational benefits, voluntary employees benefit associations (VEBAs), supplemental unemployment benefit trusts (SUBs), group legal plans, multiemployer pension plans, and airline pilot pension plans is either reduced or terminated by this year's tax law.

In addition, similar to the 1982 law, the 1984 law relies heavily on excise taxes to raise revenues. This hurts workers and low income earners, who spend more of their income, and it makes the tax system more unfair.

Other negative features of the 1984 tax law include the phase out of the 30 percent witholding tax on interest paid to foreign portfolio investors; the new Foreign Sales Corporation provisions which were established as a replacement for Domestic International Sales Corporations (DISCs); the forgiveness of billions of dollars of taxes on corporate income that DISCs have been deferring for years; and the decrease in the holding-period for long term capital gains from one year to six months.

The tax laws enacted in 1982 and 1984 raise only a small part of the revenues needed to reduce federal deficits and fund federal programs. And the tax code retains most of the features that have made it even less equitable in recent years. In contrast, the AFL-CIO strongly supports a genuine reform of the tax code that will make the tax system more productive and, at the same time, more equitable.

The Need for Tax Reform

The 1981 Tax Law and the vast array of tax loopholes have destroyed the fairness, efficiency, administrative simplicity, and the revenue raising ability of the nation's tax system. The resulting crisis has highlighted the urgent need for overhauling the tax structure.

Several different approaches to revising the tax code have been advanced. These include the proposal to adopt some form of expenditure tax as a replacement for the income tax. A value added tax or a national sales tax as a supplement to the income tax are other forms of consumption tax which have received some support. These would shift even more of the tax burden from those able to save to those who must spend large parts of their income, from capital to labor, and from rich to poor.

Another proposal that would unfairly favor those at the top is to substitute a flat rate tax for the progressive tax rate structure that we now have -- before the various credits, deductions, allowances, shelters and other gimmicks and loopholes are used by the affluent to reduce taxes. The flat rate proposal is generally accompanied by base-broadening proposals, although the implementation of one does not depend at all upon the introduction of the other.

A change from the present system to either a consumption tax, or a uniformly flat rate system, would primarily benefit the well-to-do, and harm people with low and moderate incomes.

The AFL-CIO is therefore strongly opposed to these proposed alternatives. Instead, we support retention of a tax system based on income, because income -- not consumption -- remains the best benchmark of ability to pay. The AFL-CIO also supports a progressive rate structure, because the move to a flat rate system, which raises the same revenues as current law, provides the wealthy with tax cuts that have to be offset by rate increases on the middle-class, the poor, or both.

The AFL-CIO supports a major tax reform initiative that would close loopholes that favor business and the rich, reverse some of the more unfair and unwise features of the 1981 law, keep income as the tax base, and retain a progressive rate structure.

The Expenditure Tax

Moving the tax base from income to expenditure is one proposal now receiving much attention. An expenditure based tax system would exempt savings from taxation and is therefore supported by those who believe we don't save enough.

On the surface, the administration of the expenditure tax would resemble the current income tax system quite closely. At the end of the year, individuals would calculate their income as they do now. But people would then deduct the entire amount they have saved during the year from their income. Savings of all type would be deducted, including additions to savings and checking accounts, stock and bond purchases and so forth. Borrowing represents a savings decrease, and would be subtracted from an individual's savings. Subtracting the resulting savings total from income leaves spending, which would be taxed.

Proponents of an expenditure tax argue that spending is a better measure than income of the benefits people take out of society. But the AFL-CIO supports income as the tax base because it better represents a person's ability to pay, which is the best possible equity standard we have. If, for example, one family earns $20,000 and spends it all, while another earns $100,000 and spends only $20,000 while saving the rest, an expenditure tax would tax them both the same amount. An income tax, however, properly recognizes that the higher income family has the greater ability to pay, and would tax that family accordingly.

Another purported advantage of the expenditure tax is that, under very restrictive assumptions, people with equal expected lifetime earnings would pay equal expected lifetime taxes. In a related argument, supporters of an expenditure tax maintain that consumption, not current income, is most closely related to expected lifetime income. This implies however, that people who have incomes that are lower than their lifetime trend levels --which includes the young, retired people, and the unemployed -- would have to pay higher taxes under an expenditure-based system than they would under the income tax. Moreover, the conditions required for expected lifetime taxes to equal expected lifetime incomes tax are unrealistically restrictive. The equivalence between lifetime income and taxes doesn't hold in the real world with its divergent economic conditions, periods of unemployment, other unexpected hardship, and disparate initial wealth. Equality between lifetime taxes and lifetime incomes also requires the absence of bequests.

Because savings would not be taxed under an expenditure tax, and because affluent people save much more than individuals with low and moderate incomes, the well-to-do can accumulate vast fortunes under such a system. Thus, some of its supporters acknowledge that an expenditure tax would have to be accompanied by stricter estate taxation, or the classification of gifts and bequests as a type of consumption. Without such taxes, wealth could accumulate tax free and be passed on from generation to generation, accumulating without end. In light of the reduction of estate taxes to the point of meaninglessness in 1981, it's clear the problem of wealth accumulation will not be attacked with great enthusiasm.

In exempting capital from taxation, the expenditure tax will require finding other revenue sources. Essentially, workers and the poor will bear a higher tax burden under the system.

The purpose of exempting savings from taxation is to provide an incentive for savings. Savings and investment, however, have been impervious to tax gimmickry. Further, there is no need for a savings or investment increase. Historical experience demonstrates that capital formation isn't dependent on tax incentives, nor is capital the sole or even the major source of economic growth. For example, Edward Denison -- who is a leading productivity scholar -- has estimated that education and other labor-related factors contribute far more than capital to economic growth.

Another argument advanced in support of the expenditure tax is that it will be much simpler to administer. For example, all investment assets are simply exempted from taxation, and this is said to eliminate many thorny controversies associated with the income tax. But it is very likely that many unproductive assets will be classified as capital investments, and thus be exempted from taxation. We can expect to hear that purchases of artwork, oriental rugs, and other unproductive assets somehow contribute greatly to economic growth, and that they should be classified as capital investment.

Similarly, its adherents argue that the expenditure tax, by exempting all savings and investment from taxation, will eliminate the need for the many tax loopholes in the current tax system. But this claim is based more on hope than a realistic assessment of the tax policy environment. Businesses and individuals that currently receive preferential tax treatment aren't likely to forfeit willingly their relative advantage over other businesses and individuals merely because of the adoption of spending as the tax base. Charities, for example, willbe quick to point out that their contributions will drop off without some form of tax advantage. Homeowners too will be loathe to give up the advantages they receive under the system. Similarly, corporations that receive favored tax treatment -- or even pay negative tax rates under current law -- solely because of the composition of their capital stock, aren't willingly going to forfeit such a distinct competitive advantage.

Thus, the proposition that expenditure taxes automatically lead to a neutral, and therefore economically efficient, tax structure is distinctly pollyanish. Preferential treatment won't end just because an expenditure tax is enacted. Those firms with preferred tax positions expect their market shares, their profits, or both to decline if they lose their tax benefits. Accordingly, in a real world, an expenditure tax will not provide the magic solution to the deficiencies in the nation's tax structure.

We cannot overstate the AFL-CIO's profound opposition to the expenditure tax. It is uniquely unfair because it levies a higher burden on the poor and middle income earners, who tend to spend a far greater share of their incomes than the rich.

Further, the spending based tax system would allow huge fortunes to be accumulated and passed on from generation to generation unless strict wealth and estate taxes were enacted, and recent tax reductions have demonstrated that such tightening is highly unlikely.

The expenditure tax, though touted as a way of reducing loopholes by its supporters, will not automatically eradicate tax preferences. Moreover, the expenditure tax is, in reality, nothing more than one big loophole for capital.

Thus, it requires higher taxes on labor to raise a given revenue total. It is not neutral. Instead, it lowers the cost of capital relative to labor. To the extent that firms respond to relative costs, this tends to discourage hiring people and promotes the increased use of capital.

Our most fundamental opposition to the expenditure tax is that it substitutes spending for income as the tax base. Income is the most accurate indicator of ability to pay. Fairness demands that income remain the base for the nation's tax system.

The Value-Added Tax

The value added tax, or VAT, is yet another regressive form of taxation that has received renewed support because of the severe revenue crunch confronting the government.

The VAT, common in Europe, is merely another variant of a sales tax. The tax burden falls on the consumer, and all the regressive features of an expenditure tax apply to the VAT.

Under the value added system, the federal government collects a piece of the tax at each stage of production and distribution. Through a complicated system of rebates, credits, and price adjustments, each firm is reimbursed for its share of the VAT. The total tax grows progressively larger as it is bucked forward to each firm involved in the process -- virtually every firm in our economy.

Its supporters like the advantage the VAT has over a sales tax in that it is hidden, while a sales tax is explicitly revealed to the consumer. Proponents of a national sales tax respond that a sales tax would be simpler to administer.

The AFL-CIO opposes both the VAT and a national sales tax. Their implementation would immediately be reflected in higher prices. Such taxes on consumers fall most heavily upon low and middle-income Americans, who must spend all or most of their incomes on necessities. Wealthy individuals can save and invest much of their income, thus sheltering most of their income from taxes on spending. A VAT or a sales tax would, therefore, further erode the equity of the nation's tax structure.

Flat Tax

The flat tax is another unfair alternative to restructuring the tax system that has been receiving a great deal of attention.

To the AFL-CIO the flat rate tax is fundamentally unacceptable because it is the diametric opposite of an equitable tax system. For taxation to meet the standard of fairness, it must be based on ability to pay and higher incomes must be taxed at higher rates -- its rates must be progressive, not flat.

Furthermore, the relative tax burdens of a flat rate system cannot be viewed in isolation. Instead, they must be compared to the current distribution of tax burdens.

The Congressional Joint Economic Committee on Taxation prepared a set of estimates which provides the most damaging indictment of the flat tax system. That analysis compared the effect of flat rates ranging from 11.8 percent to 18.7 percent, applied to various expanded income measures, with 1984 tax liabilities under present law. In every case, the majority of low and middle income earners suffer tax increases, while those with higher incomes enjoy substantial tax cuts.

Because the federal deficit is so huge, any flat rate system must have a rate which is high enough to raise at least the inadequate revenues that are being raised under current law. Thus, if rates are lower for those at the higher part of the income scale, they must increase for those in the low to middle income range. The consequent heavy burden on the poor can be offset by a higher personal exemption and an increased zero bracket amount. This, however, requires a higher flat rate. The increased tax burden then rests even more heavily on middle income earners, while the rich continue to pay lower taxes.

Broadening the tax base would allow a lower flat rate. But, under the most optimistic assumptions regarding loophole closing, in order to achieve even the low revenue total provided by the current tax system, the tax burden would be shifted from the rich to the middle class and -- unless the personal exemption and low bracket rate is raised sufficiently -- the poor.

Belief in the supply side benefits of a flat rate tax system requires us to accept the idea that economic growth depends only on giving everything to the rich, and that somehow their increased wealth will ultimately benefit the rest of us. It's the old discredited "trickle down" theory, dressed up in modern attire. The labor movement didn't buy the original version, and we don't buy this new rendition either.

Flat-taxers frequently include at least some loophole closing in their proposals. But closing loopholes is entirely independent from the flat tax issue. The AFL-CIO has always supported the termination of tax loopholes. The flaws and imperfections of the existing tax system -- and there are many -- have nothing to do with the fact that tax rates are graduated. The truth is that progressive tax rates are the central positive characteristic of the current tax structure. Progressivity is a desirable end in itself -- its achievement means that a lower income earner, to whom an additional dollar is worth far more than it is to an affluent person, would be taxed at a lower rate on that additional dollar. Similarly, the termination of tax loopholes which primarily benefit those at the top, is desirable in itself. Tax loopholes make the system less fair, they result in higher burdens for those who can't use them -- particularly for low and moderate income earners. And, tax loopholes are one of the most important causes of the revenue crisis now confronting the nation.

To close loopholes doesn't require a flat tax. Instead, a flat tax would make the nation's tax structure far worse than it is today. Flat taxes are a form of tax regressiveness, and have nothing to do with real tax reform.

Specific Tax Reform Proposals

Bradley-Gephardt

Senator Bill Bradley and Congressman Richard Gephardt have sponsored the Fair Tax, which would close most of the worst loopholes in the tax code while retaining progressivity in the rate structure. Bradley-Gephardt is designed to raise about the same revenue as current law, and keep the present distribution of tax burdens by income class. Its fundamental aim is to reduce the differences in effective tax rates for people with the same income.

Bradley-Gephardt would create three tax rates for individuals, 14%, 26% and 30%. Under current law, there are 15 rates from 11% to 50%. The top 30% rate would become effective at annual income levels over $37,000 for individuals or $65,000 for couples. Because the standard deduction and the personal exemption would be raised, a family of four would not have to pay taxes unless their annual income exceeded $11,200. Most unfair tax loopholes are repealed, and mortgage interest and charitable contributions could be deducted only against the 14 percent tax rate, regardless of actual income levels.

The corporate tax rate would be a flat 30 percent, compared to the 15% to 46% range under current law. Several major corporate tax benefits would be scaled back. Write-off periods for capital assets -- which were reduced to absurdly short periods by the accelerated cost recovery system of the 1981 tax law -- would be matched more closely with the actual useful lives these assets. Other useful moves include terminating the favored treatment of capital gains, and the repeal of the investment tax credit.

The AFL-CIO strongly supports Bradley-Gephardt's base broadening iniatives as well as its retention of a progressive rate structure. These two features are central to our own tax reform efforts.

We are concerned, however, that Bradley-Gephardt, as currently conceived, will only raise the same amount of revenues as the current law. The huge federal deficit is a most serious problem, which can only be addressed by a substantial increase in tax revenues. We also oppose Bradley-Gephardt's move to end the exclusion of medical insurance contributions as a means of curbing medical care costs, and we are concerned with the net effect on workers of some of the specific proposals in the bill.

Equality of tax rates for individuals earning the same income is only one test of fairness that any tax system must pass. People with higher incomes can afford to pay higher rates, and should be required to do so. Thus, Bradley-Gephardt's retention of a progressive tax structure is an important feature in its favor. Nonetheless, an even greater degree of progressivity should not be ruled out, particularly when such a large increase in federal revenues is needed.

Kemp-Kasten ("Fast")

Representative Jack Kemp and Senator Robert Kasten have proposed another version of the modified flat tax, which is called a fair and simple tax, or "Fast."

Kemp-Kasten would impose one 25% rate on all income, with 20 percent of income exempted for those with incomes up to $39,300 a year.

But, under this proposal, the accelerated cost recovery system would be retained, capital gains would still receive hefty tax preferences, and the foreign tax credit would remain in effect.

Under Kemp-Kasten, business and the rich receive far greater benefits than under Bradley-Gephardt. Congressional staff estimates indicate that Kemp-Kasten gives people earning over $100,000 very large tax reductions.

The AFL-CIO opposes Kemp-Kasten, which is just another move to shower more advantages on the rich at the expense of the rest of us.

The AFL-CIO Tax Reform Proposals

The AFL-CIO supports a major tax reform initiative based upon fairness and the need to raise enough revenues for the federal government to carry out its many very important responsibilities. For any tax reform proposal to be fair, income must be retained as the tax base, and the rate structure -- as well as actual effective tax rates -- must be progressive.

The AFL-CIO's tax reform proposal calls for the termination of loopholes that favor business and the rich, and the reversal of some of the more unfair and unwise features of the 1981 Tax Act.

Basically, we recommend the approach adopted in February, 1983, by the AFL-CIO Executive Council. That program, through a combination of measures addressed to the 1981 Act, and some fundamental reforms, would raise the needed revenues, and lead to a fairer tax code, capable of sustaining economic recovery.

A principle cause of the deficit crisis is the 1981 Tax Cut, and raising revenues requires a major revision of some of the worst features of the 1981 law.

We support a **cap on the personal tax cut** that would limit the third year of the tax cut to $700.

A key element of the AFL-CIO's tax justice program is repeal of the **indexation** provisions of the Economic Recovery Tax Act of 1981. Repeal of indexation will increase revenues by $6.2 billion in fiscal year 1985 and $16.7 billion in fiscal year 1986.

Without indexing, the system of progressive tax rates automatically serves as a contracyclical force, moderating excessive demand during inflationary periods and helping to sustain purchasing power during recessions. If indexing goes into effect, however, the tax structure will automatically adjust in a procyclical fashion, adding momentum to inflations and recessions. Moreover, the ability of government to use discretion in the conduct of tax policy would be severely curtailed by the linking of tax rates to the rate of inflation. Monetary policy would become an even more dominant factor in the economy.

Another tax loophole mistakenly characterized as a savings incentive is the exemption from taxation of **individual retirement accounts**. The higher a taxpayer's income, the greater is the tax windfall this gimmick provides. To make the IRA somewhat more equitable, the tax benefit should be changed from an exclusion from gross income to a credit which would provide the same dollar benefit amount regardless of the taxpayer's bracket.

Another feature of the tax code high on our list is the 60 percent exclusion from income of **capital gains.** Combined with the lowering of the maximum tax rate to 50 percent by the 1981 Tax Law this exclusion reduces the maximum tax rate on capital gains to only 20 percent. This exclusion costs the Treasury $18 billion a year in revenues and primarily benefits the wealthy -- with the top 5 percent of taxpayers getting 60 percent of the benefits. The 1984 law has now reduced the holding period for long term capital gains from one year to six months and will result in additional revenue losses. This new gimmick should be reversed.

The AFL-CIO supports restoring the capital gains exclusion to the 50 percent level that prevailed before 1979, and beginning in 1985, the exclusion should be phased out over a 5-year period, with adequate protection for homeowners. This would raise nearly $3 billion in FY 1985 and over $5.0 billion in FY 1986.

The federal tax system was tilted further in favor of the wealthy by the virtual elimination of the **Estate and Gift** Tax in 1981. The 1984 tax law delayed the reduction from 55 to 50 percent, in the top estate and gift tax rate that was scheduled for 1985. The 55 percent rate will remain in effect through 1987. When the rate cuts and increases in exemptions enacted in 1981 are fully phased in, only

0.3 percent of all estates will be subject to estate taxes, and the liabilities of these few estates that are taxed will be substantially reduced.

The reduction of estate and gift taxes eliminates an important and equitable constraint on the accumulation and intergenerational transfer of vast fortunes. Equity considerations require effective taxation of accumulated wealth and the recent array of exemptions of capital from taxation makes this even more urgent.

Restoration of the estate and gift tax to its former structure, which allowed $250,000, or over half of the estate (whichever is greater) to be passed on to the surviving spouse tax free and provided generous credits for heirs would raise $3.7 billion in FY 1985, and $5.0 billion in FY 1986.

As a result of the business provisions of the 1981 Tax Act, the corporate income tax has been virtually eliminated. We call for reinstatement of the corporate income tax as a source of revenue, equity, and economic balance. Primarily because of the accelerated cost recovery (ACRS) provisions of the 1981 act, corporate tax revenues for the 1983 and 1984 budgets are estimated at only $35.3 and $64 billion, respectively. At these levels, corporate receipts will be only 5.9 percent of total 1983 budget receipts and 9.6 percent of anticipated 1984 revenue. In 1980, the ratio was 12.5 percent, and in 1970, it was 17 percent. In 1960 -- before the enactment of depreciation speed-ups, the investment tax credits, and rate reductions -- the corporate income tax financed nearly 25 percent of the entire federal budget. If the corporate income tax were to bear the same share of the federal tax burden in 1984 as it did in 1980, receipts would be $20 billion higher. (See the attached chart illustrating the sources of federal revenues.)

We also support the restoration of a portion of lost corporate tax receipts by ending the tax subsidies that encourage the overseas operations of U.S.-based multinational corporations. These preferences have eroded the tax structure, destroyed American jobs, and spurred the outflow of U.S. capital, technology, and know-how.

Specifically:

- **Foreign Tax Credit:** The present practice of allowing dollar-for-dollar credits against a multinational company's U.S. income tax liability is a loophole which encourages U.S. corporations to produce abroad. Foreign taxes should be deducted just like state taxes and other costs of doing business.
- **Deferral:** The deferral privilege allows multinational corporations to defer U.S. income tax payments on the earnings of their foreign subsidiaries until such profits are brought home -- which may never occur.
- **Foreign Sales Corporation (FSC):** Although the 1984 tax law terminated the Domestic International Sales Corporation (DISC) program, it replaced it with the new Foreign Sales Corporation (FSC) provisions, and it forgave the taxes on income that DISCs have been deferring for years. The Foreign Sales Corporation program, which allows deferral of taxes on profits of export subsidiaries, should be repealed, and the taxes deferred through DISC should be collected.

Ending these three foreign tax subsidies would raise $6.5 billion in revenues in FY 1984 and over $33 billion in the 1984-1986 period.

The Investment Tax Credit: In 1982 Congress went halfway toward eliminating the practice of deducting, as depreciation allowances, costs that were already deducted as investment credits. If the job was completed and business was required to reduce the depreciation base by the full ITC rather than only one-half, over $4 billion would be recaptured in the 3-year 1984-1986 period. Cutting the credit back from 10 percent to its previous 7 percent level would raise over $14 billion in the 1984-1986 period.

Oil and Gas: High on the list of unfinished business is the elimination of the special tax loopholes for the oil and gas industry. Eliminating percentage depletion and the immediate expensing of drilling costs and terminating the 1981 law's Windfall Profit Tax changes would increase revenue in 1984 by $3.7 billion and generate a cumulative revenue increase of over $15 billion during the 1984-1986 period.

We also believe that a temporary surtax should be enacted to meet the current defense budget needs. Such a tax should be levied on both corporations and individuals; the rate should be graduated, and it should include as part of its base the income that currently escapes tax through phantom write-offs, special exclusions and shelters -- it could raise annual revenues by as much as $30 billion.

In conclusion, to reduce the huge federal deficits and strengthen this country's economic future, the AFL-CIO supports a comprehensive tax reform program that will both raise revenues and restore fairness to the tax code.

Under a comprehensive approach to tax reform, the numerous loopholes that disproportionately favor business and the rich must receive primary attention. Terminating the few hard-won benefits that help workers and the less advantaged members of society is not comprehensive tax reform.

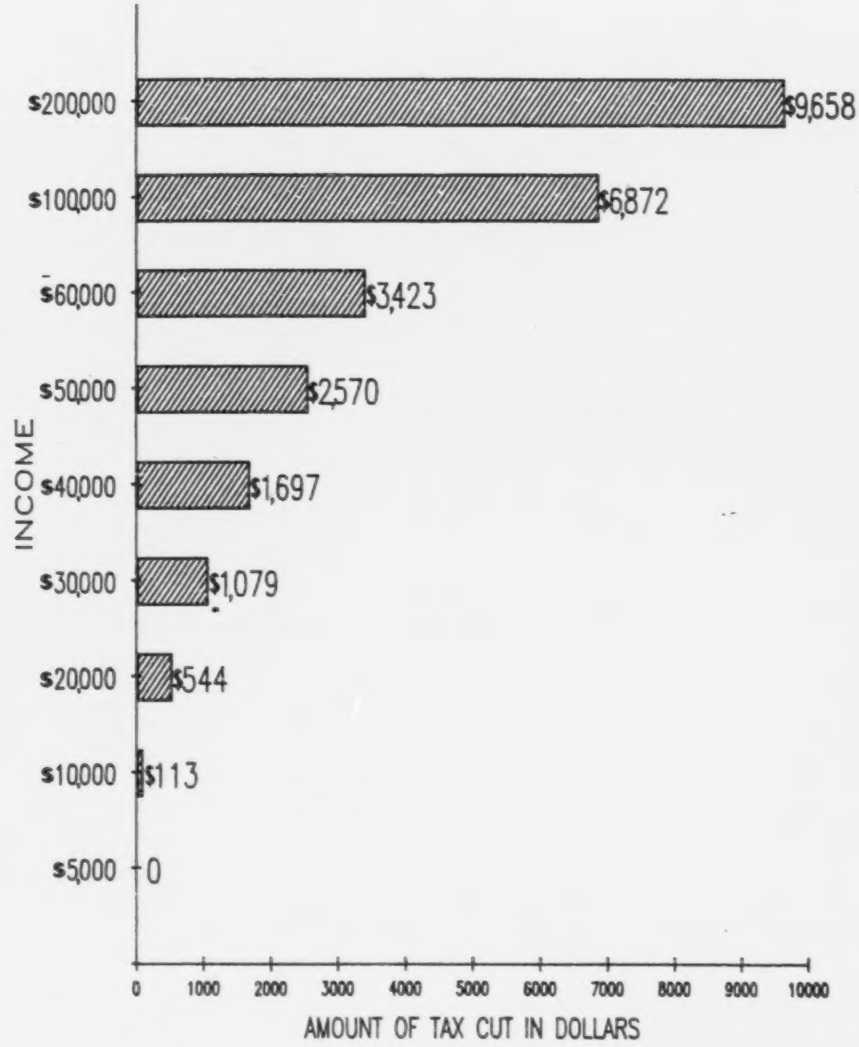
Such unfair and gimmicky proposals as an expenditure tax, a value-added tax, a national sales tax or a flat tax, shift even more of the tax burden to middle and low-income earners, and fail the test of equity based on the principle of ability to pay. Real tax reform will retain income as the tax base, keep a progressive rate structure, close the loopholes that favor business and the affluent, and reinstate the revenue-raising ability of the tax system.

A comprehensive program based on these principles will enhance equity, cut the deficit, and improve the underlying structure of the nation's economy.

Table I
Outlays and Receipts for Selective Trust Funds
1983 - 1985
(In $ millions)

	(Actual) 1983	(Estimated) 1984	 1985
Social Security			
Outlays:	172,280	181,707	193,161
Receipts:	172,492	178,446	200,103
Unemployment Comp.			
Outlays:	32,655	24,800	24,700
Receipts:	31,620	28,100	27,700
Medicare			
Outlays:	56,868	66,176	75,858
Receipts:	63,096	67.870	76,832
Civil Service & Railroad Retirement			
Outlays:	27,801	28,604	31,571
Receipts:	41,165	45,394	48,277

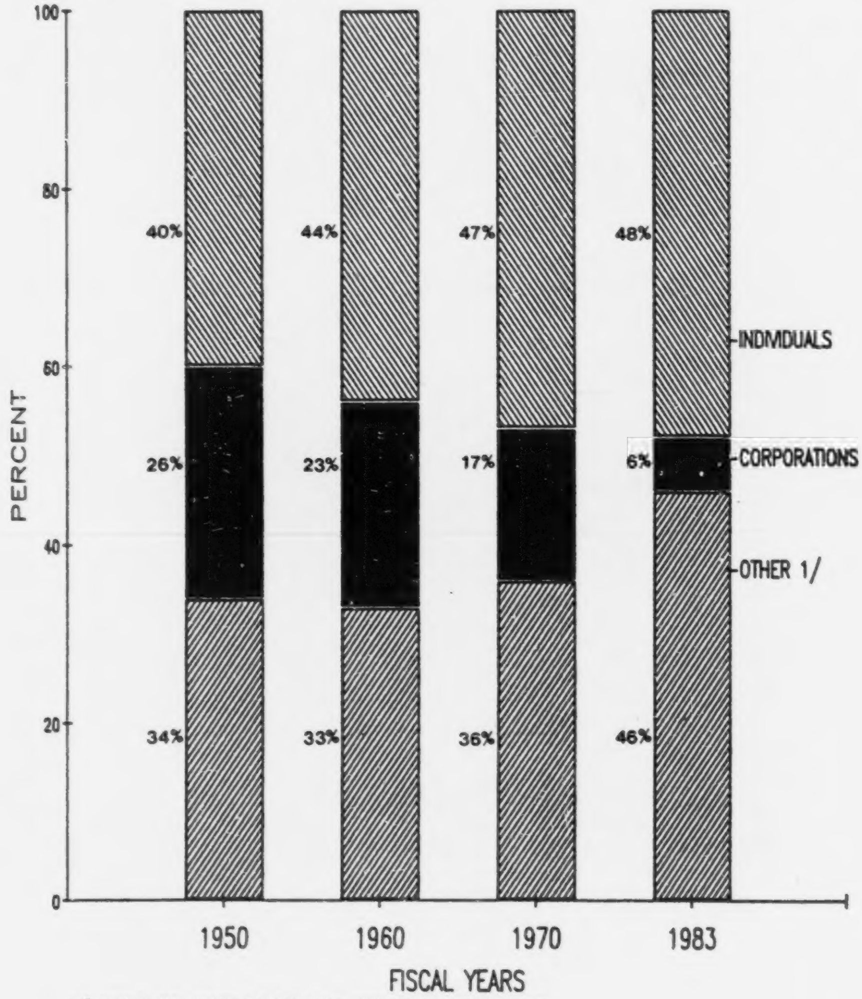
Who Gets the Most in the Third Year of The 1981 Tax Cut?



SOURCE: HOUSE BUDGET COMMITTEE

Source of Federal Tax Revenues

Corporations Have Shifted Their Share of the Costs of Government onto Consumers and Workers



1/ OTHER INCLUDES SOCIAL SECURITY AND EXCISE TAXES

SOURCE: HOUSE BUDGET COMMITTEE

STATEMENT OF HOWARD PHILLIPS, NATIONAL DIRECTOR, THE CONSERVATIVE CAUCUS, INC., WASHINGTON, DC

Mr. PHILLIPS. Mr. Chairman, thank you very much for giving us the opportunity to appear. The complete details of the 10-percent flat-tax proposal which The Conservative Caucus endorses is included in my testimony, and I will let you read that for yourselves.

Let me just say that the two principal objectives of the 10-percent flat-tax proposal which we are endorsing, incorporated in Congressman Siljander's bill H.R. 5432, are tax equity, the principle that everyone should pay the same rate of tax, and tax reduction.

Unlike some of the other proposals which have been presented to you, we hold out the distinct possibility that the Siljander plan might lead to a reduction in revenues, and frankly we welcome that.

Former Assistant Secretary of the Treasury Paul Craig Roberts, in an analysis of tax reform proposals published in Human Events on July 21, 1984, had this to say about the 10-percent flat rate tax:

> Mark Siljander, a Republican from the Fourth District of Michigan, is holding everyone's feet to the fire with his Ten Percent Flat Tax Rate Act. This bill retains the same popular deductions but imposes a much lower rate. With its $2,000 personal exemption indexed for inflation, it would largely exclude low incomes from taxation.
>
> Siljander's bill contains a 3-year amnesty provision, designed to put back on the tax rolls evaders who are withholding from the Treasury an estimated $80-110 billion annually. Congressman Siljander believes this sum would cover the revenue shortfall from the 10-percent rate, and if not, he is prepared to freeze spending until economic growth and tax revenues catch up with the Government's budget.
>
> Siljander's tax has another distinctive feature: It is set at the rate of the religious tithe, reminding everyone of the multiple demanded by Caesar over God.
>
> It was only one lifetime ago that the income tax was introduced into our country. The enormous escalation in central government power that has taken place in the time frame of a single lifetime is unprecedented in history.

And Secretary Roberts continues:

> Of the proposals being considered, Siljander's would come closest to restoring the balance between the individual and the State that existed during most of our history.

I might point out that there are already some 36 Members of the House of Representatives who have cosponsored this bill, which was introduced on April 11, and we look forward to Senate cosponsorship in the near future.

Historically, tax increases have been used not to reduce deficits but to increase spending. In fiscal year 1980, Federal spending was $576 billion on budget. Taxes collected that year by the Federal Government amounted to some $517 billion. During fiscal year 1985 it is estimated by the U.S. Office of Management and Budget that the Government will collect $745 billion in taxes, $228 billion more on an annual basis than was collected at the start of the Reagan administration. Despite this fact, the deficit has grown from $59 billion in 1980 to more than $180 billion estimated for fiscal year 1985—not because taxes are too low, but because spending is too high, having been increased from $576 billion annually to now what is estimated at $925 billion.

It is our position that Federal spending should be held to a level which can be supported by the revenues to be yielded by a 10-percent flat-rate tax. The issue is not what Congress wants to be spending but what the American taxpayer ought to be paying.

Thank you.

The CHAIRMAN. Mr. Lynch.

[Mr. Phillips' written testimony follows:]

Statement by Howard Phillips
Chairman
The Conservative Caucus, Inc.

Former Assistant Secretary of the Treasury, Paul Craig Roberts, in an analysis of tax reform proposals published in Human Events on July 21, 1984, had this to say about the ten percent flat rate tax:

"Mark Siljander, a Republican from the 4th District of Michigan, is holding everyone's feet to the fire with his 'Ten Percent Flat Tax Rate Act' (HR 5432). This bill retains the same popular deductions, but imposes a much lower rate. With its $2,000 personal exemption indexed for inflation, it would largely exclude low incomes from taxation.

"Siljander's bill contains a three-year amnesty provision designed to put back on the tax rolls evaders who are withholding from the Treasury an estimated $80-$110 billion annually. Siljander believes this sum would cover the revenue shortfall from the 10 per cent rate, and, if not, he is prepared to freeze spending until economic growth and tax revenues catch up with the government's budget.

"...Siljander's tax has another distinctive feature---it is set at the rate of the religious tithe, reminding everyone of the multiple demanded by Caesar over God. It was only one lifetime ago that the income tax was introduced into our country. The enormous escalation in central government power that has taken place in the time frame of a single lifetime is unprecedented in history.

"...[Of the proposals being considered] Siljander's would come closest to restoring the balance between the individual and the state that existed during most of our history."

The Conservative Caucus supports H.R. 5432, The 10% Flat Rate Income Tax, introduced by Congressman Mark Siljander (R-MI) on April 11, 1984 and currently co-sponsored by 36 House members. A Senate version of the House bill will be introduced soon.

H.R. 5432 would establish several exclusions from gross income: 1) alimony and separate maintenance payment; 2) scholarship payments and fellowship grants; 3) Social Security payments; 4) Social Security tax payments (in excess of the amount prescribed by FICA); 5) disability payments; 6) Railroad Retirement Act payments; 7) former government employee retirement benefits (the amount from Social Security only); and 8) interest payments on state, county, or municipal bonds.

Allowable deductions from gross income would include: 1) trade and business deductions; 2) trade and business deductions of employees; and 3) expenses relating to income production. In addition, adjusted gross income would be reduced by deductions for all interest payments and taxes, charitable contributions, and payments for IRA and Keogh plans.

The Siljander 10% flat tax plan would raise the personal exemption and exemption for dependents to $2,000 per person, with exemptions indexed to the rate of inflation.

The Siljander bill would repeal the inheritance tax and reduce the tax on income from trusts and estates to 10%. [See H.R. 5432 section 641 and section 900 (U.S. Code Subtitle B, chapter 11, sections 2001 through 2209 are repealed)]

The tax on capital gains would also be cut to 10%, providing added stimulus for investment and economic growth.

H.R. 5432's amnesty provision would establish a three-year period during which citizens would be allowed into the tax system without fear of civil or criminal penalty. Interest payments on back taxes should, in my view, be required. Amnesty would induce many of those now in the underground economy to enter the system. Additional revenues during the three-year transition could be quite significant.

H.R. 5432 offers true tax reform. It will move us away from the discriminatory and anti-productive biases implicit in the graduated system, and instead have everyone paying the same percentage of income in taxes. True equality before the law requires equality before the Internal Revenue Service.

A uniform 10% rate for all taxpayers will place an additional restraint on attempts to solve problems of overspending by raising taxes. When a national constituency for a permanent, fixed rate has been established, resistance to increases will be greater. Furthermore, backdoor manipulation of the revenue code will be far more difficult to disguise.

America needs a fair and simple tax standard, such as that embodied in the Siljander bill, which encourages the minimum possible interference with market-oriented decision making.

Bradley-Gephardt, with three discrete tax brackets, would be an easy vehicle for manipulation by Congress, permitting an increase in the rates on one class of taxpayers at a time, dividing what would otherwise be a more comprehensive opposition to tax increases.

Graduated rates is not the only flaw implicit in the Bradley-Gephardt proposal. Bradley-Gephardt would not only repeal most of the existing exemptions and deductions available to those attempting to escape high marginal rates of taxation, it would also make previously tax-free fringe benefits subject to tax. Defining fringe benefits as wages is not tax reform. It is an added form of interference in the private economy.

Bradley-Gephardt would also eliminate tax indexing, now set to go into effect in 1985, thus perpetuating automatic, inflation-induced tax hikes through bracket creep. Soon, with no increase in real income, all taxpayers would find themselves being boosted ever closer to the maximum Bradley-Gephardt bracket of 30%, while having lost many of the buffers built into the present tax code.

Unlike the Siljander bill, Bradley-Gephardt would maintain the present inheritance tax system, and tax income from trusts and estates at 30%. This confiscatory tax policy is an anti-family scheme which undermines rights of property, and discourages long-term economic stability and growth.

Bradley-Gephardt would also repeal the lower tax rate for long-term capital gains (see H.R. 3271 section 241) and raise the maximum rate for gains from 20% to 30%.

Bradley-Gephardt would adversely affect businesses and corporations, especially small businesses, by establishing an uniform 30% rate. That would double the small business tax rate on the first $50,000 earned.

Bradley-Gephardt would also eliminate small business expensing of the first $10,000 of business property and repeal the Accelerated Cost Recovery System, replacing it with retarded depreciation schedules stretched out to a maximum of 40 years.

Kemp-Kasten, although it relies on a 25% basic rate, is not a pure flat rate income tax. The so-called 20% "income exclusion" provision, would in fact result in a graduated rate structure for those with incomes above $40,000 up to $100,000.

Like Bradley-Gephardt, Kemp-Kasten would repeal the lower tax rate for long-term capital gains, raising the rate from 20% to 25%.

Kemp-Kasten would do nothing to improve the confiscatory nature of the current inheritance tax and taxes on income and estates, leaving the maximum rate at 50%.

In a provision similar to Bradley-Gephardt, Kemp-Kasten would treat some employer fringe benefits as in gross income, increasing the amount of taxpayer liability.

Both Bradley-Gephardt and Kemp-Kasten would be revenue-neutral, according to a recent study by the Institute for Research on the Economics of Taxation (see Economic Policy Bulletin, "The Not-So-Level Playing Field of Revenue Neutrality" IRET, July 26, 1984, p. 8).

Historically, tax increases have been used not to reduce deficits, but to increase spending. In Fiscal Year 1980, Federal spending was $576 billion, on budget. Taxes collected by the Federal government amounted to $517 billion.

During Fiscal Year 1985 it is estimated by the U.S. Office of Management and Budget that the government will collect $745 billion in taxes, $228 billion more than was collected at the start of the Reagan Administration. Despite this fact, the deficit has grown from $59 billion in 1980 to more than $180 billion estimated for

Fiscal Year 1985---not because taxes are too low, but because spending is too high, having been increased from $576 billion to an estimated $925 billion.

Federal spending should be held to a level which can be supported by the revenues to be yielded by a 10% flat rate tax. The issue is not what Congress wants to be spending, but what the American taxpayer ought to be paying.

On behalf of The Conservative Caucus, I urge this committee to support H.R. 5432, the Siljander 10% Flat Rate Income Tax.

Howard Phillips

Chairman

The Conservative Caucus, Inc.

Enclosure

CONTROVERSIAL PROVISIONS IN KEMP-KASTEN AND BRADLEY-GEPHARDT

1) A) Kemp-Kasten sets a flat rate of 25% on income, but with the addition of an income exclusion provision the system becomes graduated as Bradley-Gephardt. 20% of income up to approximately $40,000 is excluded, and then the exclusion is gradually phased out until, at approximately $100,000 of income, no income is excludable. For incomes under $40,000, the effective tax rate is approximately 20%. From $40,000 to $100,000 the effective tax rate is approximately 28%, over $100,000 the tax rate is 25%. B) Bradley-Gephardt contains three rates of 14%, 28%, and 30%. C) Siljander contains one flat rate of 10%.

2) A) Under Kemp-Kasten, the rate of taxation for corporate income is graduated, not flat. There is a rate of 15% of taxable income that does not exceed $50,000, and 30% of taxable income that exceeds $50,000. B) The corporate tax rate for Bradley-Gephardt is 30%. C) The Siljander bill does not address the issue of corporate taxation.

3) A) Kemp-Kasten will include in gross income any appreciation in the value of life insurance policies over the amount of the premiums paid during the taxable year. B) Bradley-Gephardt contains the same provision. C) Siljander makes no change from current law.

4) A) Kemp-Kasten does not allow deductions for local taxes. B) Bradley-Gephardt does not allow deductions for local taxes either. C) The Siljander bill allows personal property and sales taxes to be deductible as under current law.

5) A) Under Kemp-Kasten, capital gains are taxed at 25% with the basis indexed for inflation. B) Under Bradley-Gephardt, capital gains are taxed at the individual's tax rate, with the maximum rate being 30%. The basis is not indexed for inflation. C) The Siljander bill taxes gain at only 10%.

6) A) Kemp-Kasten requires that the itemized deduction for medical expenses be limited to the excess of over 10% of AGI, up from 5% under present law. B) Bradley-Gephardt requires the same. C) Siljander offers no deduction for medical expenses.

7) A) Kemp-Kasten taxes the income from trusts and estates at current income tax rates, up to 50%. B) Bradley-Gephardt also taxes the income from trusts and estates at current income tax rates. C) Under the Siljander bill, income from trusts and estates is taxed at the 10% flat rate.

8) A) Kemp-Kasten keeps the current inheritance tax system intact, with rates up to 50%. B) Bradley-Gephardt also keeps the current inheritance tax system. C) The Siljander bill repeals the inheritance tax completely.

9) A) Kemp-Kasten includes employer-provided health insurance benefits in gross income. B) Bradley-Gephardt includes both employer-provided health and life insurance in gross income. C) The Siljander bill does not, just as current law.

10) A) Kemp-Kasten repeals the marriage deduction, but keeps a graduated rate structure. B) Bradley-Gephardt also repeals the marriage deduction but keeps a graduate rate structure. C) The Siljander bill also repeals the marriage deduction, but the tax rate is lowered to 10%.

11) A) Kemp-Kasten repeals the interest exemption for Industrial Development Bonds and Mortgage Subsidy Bonds. B) Bradley-Gephardt also repeals the interest exemption. C) The Siljander bill maintains current law where both are interest exempt in most cases.

POSITIVE PROPOSALS

1) A) Kemp-Kasten provides for the indexing of the basis of an asset in determining the gain or loss on the investment. This provision helps to offset "inflated" gains due to the inflation rate. Since capital gains will be taxed at 25%, this provision will lessen the tax burden. B) Bradley-Gephardt does not offer indexing of basis, and the maximum tax rate is 30%. C) Siljander does not offer basis indexing, but the tax rate is only 10%.

2) A) Kemp-Kasten retains the Accelerated Cost Recovery System, which is an improvement over pre-1981 depreciation schedules. B) Bradley-Gephardt repeals ACRS and replaces it with a retarded depreciation schedule which resembles pre-1981 schedules. C) Siljander repeals all depreciation schedules and provides for immediate expensing (write-off).

3) A) Kemp-Kasten raises the personal exemption to $2,000. B) Bradley-Gephardt raises the personal exemption to only $1,600. C) Siljander raises the personal exemption to $2,000.

STATEMENT BY JOHN C. LYNCH, LEGISLATIVE COUNSEL, CITIZEN'S CHOICE, INC., WASHINGTON, DC

Mr. LYNCH. I want to thank the members of this committee for giving the 75,000 members of Citizen's Choice an opportunity to have their opinions known on this important topic.

Citizen's Choice has been involved, Senator Dole, as you suggested, in setting the stage for tax reform since 1981 when they issued their National Commission on Taxes and the IRS final report. This commission heard testimony from taxpayers across the Nation. And speaking on behalf of those taxpayers and the 75,000 members of Citizen's Choice, I have to say that we are quite ready. We believe that the stage is set, and we are very anxious for the curtain to go up on this tax reform play. And when it does, we are anxious that eight principles be included into any consideration of how we reform the system:

First, tax reform must not become a euphemism for tax increases.

Second, tax reform should reduce or eliminate the present system's pervasive bias against savings and investment.

Third, tax reform should dramatically simplify the Tax Code and reduce the administrative burden on the taxpayer.

Fourth, tax reform should reduce marginal income tax rates.

Fifth, tax reform should reduce or eliminate the progressivity of our tax system.

Sixth, tax reform should retain indexing, so that the Government may not surreptiously profit from inflation.

Seventh, tax reform should not mislead the public regarding the amount of tax that they are actually paying.

And finally, and because this issue is tied up with regard to the question of tax reform, the deficit should not be reduced by tax increases but rather should be reduced by spending reductions and economic growth.

Given the time limits involved, that is the conclusion of my testimony. I want to offer to this committee our assistance in any way they might find it helpful in working toward our common goal of a reformed tax system.

Thank you.

The CHAIRMAN. Mr. Jones.

[Mr. Lynch's written testimony follows:]

STATEMENT ON TAX ALTERNATIVES

by

John C. Lynch
Legislative Counsel
Citizen's Choice, Inc.

I am John C. Lynch, Legislative Counsel of Citizen's Choice, a national grass-roots taxpayers' organization founded in 1976. Citizen's Choice currently has over 75,000 taxpaying members nationwide, representing all sectors of our society.

I am pleased to have this opportunity to testify before this Committee on the topic of tax alternatives. Citizen's Choice is uniquely qualified to present testimony on this subject. Our National Commission on Taxes and the IRS conducted a nationwide investigation of taxpayers' attitudes toward the IRS. In response to the Commission's finding that our tax system is in need of massive reform, we commissioned a study that addressed the pros and cons of a variety of alternative tax systems and which served as discussion material for three Citizen's Choice-sponsored tax forums on the topic. Today, I will outline the findings and conclusions of our efforts.

The United States has a tax system under which some millionaires can get away with paying no income tax at all, while people who earn $60,000 a year may pay nearly half their income in taxes. It is not surprising, therefore, that the system is viewed by taxpayers as inequitable. We have a system in which each piece of tax legislation passed by Congress is added to the fourteen volumes and more than 7,000 pages of rules and regulations comprising the present Internal Revenue Code. Considering this, it is also not surprising that the system is seen as complicated.

Moreover, when revenue loss from "underground" economic activity is estimated at more than $100 billion annually -- it is not surprising that the present system is viewed as inefficient. Tax avoidance and tax evasion are becoming a national pastime. And incidents of IRS abuse, borne of frustration in enforcing our tax laws, are becoming commonplace. It is high time for meaningful tax reform.

For this reason, the proposal of a flat rate or broad based tax with low marginal rates has generated considerable legislative and popular interest in the last year. From tax experts to taxpayers, the opinion is the same -- our present system of voluntary taxation is headed for disaster. It has become extremely complex and unwieldy. It has drifted away from its original purpose of raising revenue and has become a tool for promoting specific social and economic goals. So, whether it is the charitable deduction or the energy credit, the idea is no longer simply to fund government operations but to help elements of our society to succeed. And, while there is nothing insidious about this policy, it becomes a great problem when exclusions, deductions, exemptions and credits become the norm rather than the exception in the tax code.

The medical expense deduction is a classic example. Congress wished to relieve those taxpayers who incurred large medical expenses. The result was a tax deduction for the amount of medical expenses that exceeds 5 percent of the taxpayer's adjusted gross income. But the medical expense deduction did not cover the cost of prescription drugs. For those individuals whose drug expenses were unduly large, Congress passed a tax deduction for the amount that exceeds one percent of adjusted gross income. Finally, Congress wanted to include a deduction for those individuals who have medical insurance and would normally not spend more than 3 percent of their gross income on medical bills. The result was the recently repealed $150 medical deduction for those who pay for medical insurance.

Each of the above was well intended. But in practice they cause more confusion than anything else. Recent IRS statistics reveal that more than 75 percent of taxpayers who claim any one of these deductions make mistakes in computing the amount of their deduction.

As this example illustrates, there can be no argument on whether meaningful tax reform should be undertaken. There is considerable diversity of opinion, however, on what direction tax reform should take. Should the rate structure be flat or graduated? Should the tax be based on income or consumption? What should the actual numbers be?

Citizen's Choice does not endorse any particular tax alternative proposal. But, setting aside the technical questions that must be addressed when considering alternative tax systems, I would like to comment on the theoretical advantages of adopting a simplified tax system. Since the present system is complicated, unfair and inefficient, any substitute ought to substantially improve on these flaws and at the same time be sensitive to inflation. In addition, any alternative should result in lower taxes for all Americans.

Probably the most commonly heard criticism of the present system is that its complexity causes administrative difficulties. At present, the Internal Revenue Service is capable of auditing only 1.5 percent of the returns that are filed annually. The result is that a large percentage of taxpayers overstate the amount of deductions they are entitled to, knowing that they will probably escape an audit. On the other hand, the complexity of the tax code breeds a huge number of mistakes that may or may not be picked up by computer scanning of returns. If an error is detected, it requires human involvement, which once again strains an already overburdened agency.

A simplified tax system could conceivably reduce the IRS to a block full of computers and the technicians necessary to run them. Moreover, there would be less need for taxpayers to employ a tax specialist, accountant or attorney. Since 52 percent of the people who itemize deductions seek professional assistance in preparing their tax returns, a simplified system would be less expensive to comply with. It could also result in a higher rate of compliance and equal, if not higher, amounts of revenue.

The benefits to our economy under a simplified system would be even greater. Under the current system, there are incentives to artificially shelter income from taxation at high marginal rates. These tax shelters distort the economy. Under a simplified system, investors would not need to consider the tax consequences of their investments. Money would be invested in those areas that would result in the highest pre-tax return, not in areas that have a particular tax advantage.

The obvious advantages of a simplified tax system demand that this idea be given serious consideration. Citizen's Choice has taken the lead in bringing the issue to the forefront and promoting the debate. We have sponsored three tax forums at which distinguished legislators, economists, tax specialists and business leaders worked on developing a viable proposal for reforming the federal income tax code. The first meeting of the "National Forum on Tax Alternatives" resulted in a signed resolution calling on the Finance and Ways and Means Committees to hold hearings on the subject of tax simplification. The second forum focused primarily on the question of how to define the tax base. All three meetings stressed the advantages of simplifying the present system while recognizing the difficult transitional problems to be confronted.

Today's hearings are another significant step in the tax simplification effort. We commend this Committee for recognizing the need for meaningful tax reform and for fostering informed debate on the topic.

We are now at the stage where this debate must turn from the theoretical to the practical aspects of tax reform. This necessitates deferring to the economists and tax experts who must construct a new tax system that has revenue-raising as its primary goal, that promotes savings and investment and that reduces the tax burden. We recognize that this cannot be done overnight. But we urge you to take whatever action is necessary to see that tax reform is accomplished. On behalf of the members and staff of Citizen's Choice, I offer to the members of this Committee our assistance in any way it might find it helpful in reaching our common goal of a more efficient, equitable and simple system of taxation. We look forward to working with you to this end.

STATEMENT BY JIM JONES, MANAGING DIRECTOR, GOVERNMENT RESEARCH AND DEVELOPMENT FOUNDATION, BLANCO, TX

Mr. JONES. Mr. Chairman, thank you again for the opportunity to testify at this second set of hearings.

In 1 minute, I can mention but a few compelling points.

The CHAIRMAN. We are going to give you 3 minutes.

Mr. JONES. Three minutes? I don't have 3 minutes, but I'll take 3 minutes. [Laughter.]

I'll start this sentence over again.

In 1 minute I can mention but a few compelling points illustrating our need for systemic change such as the gross income tax in our Federal tax system.

GIT would have low rates, somewhere between 4 percent and 6 percent, thereby eliminating incentives for the underground economy and the much-sought-after tax shelters and loopholes. GIT would give the Congress a simple, high leveraged tool to control deficits and the budget.

GIT would easily and quickly lend itself to computerization and electronic fund transfer GIT would allow businesses to work on an economic basis instead of a tax basis, and allow for true economic capital formation.

GIT would change public and IRS attitudes from those of an adversarial nature to those of a cooperative nature. GIT would eliminate double taxation.

And finally, GIT would fit the four basic criteria for a good tax system—that is, fairness and equity, simplicity, efficiency, and neutrality.

Mr. Chairman, let the nation proceed to a sane, mature, and proud Federal tax system.

Now, I have submitted some remarks for the record.

Senator PACKWOOD. Thank you very much.

[Mr. Jones' written testimony follows:]

STATEMENT BEFORE
THE
COMMITTEE ON FINANCE

AUGUST 9, 1984
HONORABLE ROBERT J. DOLE, CHAIRMAN

GOVERNMENT RESEARCH
AND
DEVELOPMENT FOUNDATION

JIM JONES, MANAGING DIRECTOR
309 MAIN STREET
BLANCO, TEXAS 78606

The Federal income tax system is a government function that has incestuously bred into itself an innate sense of pessimism for the average taxpayer. Everywhere one discusses the subject, the eternal expletive is "something has got to be done." Well, our Congress every year does do something. It increases the complexity -- it decreases the base by granting continuing special interest deductions, exclusions and preferences. In so doing there is a concomitant increase in the fairness gap between different taxpayer groups.

In the past the Congress has attempted to address each new measure of inequity by passing still more legislative patches (amendments) which are supposed to remedy the situation -- according to the special interest which claimed that particular inequity. Now 70 years and 8,000 pages of fine print later, the Net Income Tax (NIT) System has reached intolerable levels of administrative inefficiency; erosion of the tax base until the system can no longer support the government; vast decreases in the neutrality of the system; increased public attitudes of distrust, and a more determined effort by special interest lobbyists to make the tax law more favorably disposed toward them and at the expense of other taxpayers.

Recognition by many that this is true has been evidenced by the bringing forth of the Gross Income Tax (GIT) in 1975; the "Cash Flow" or "Consumption" Tax in 1977; the Hall-Rabushka Tax in 1979; the Value Added Tax (VAT) in 1980 and a frenzy of "Flat Rate" proposals in 1982-83-84.

Of all the proposals which have the revenue-raising capability to replace the Net Income Tax (NIT) System, none except the Gross Income Tax (GIT) or the National Sales Tax (NST) address the fundamental problem of the base to which the rate (flat or otherwise) would apply. The fundamental problem is that our tax system is based on net income. When a taxpaying business entity figures its taxable income it contorts in every conceivable fashion to reduce its net income for tax purposes while at the same time increasing its net income for purposes of pure economic gain. This tug of war between the desire for low taxable income and high economic income has produced our present anarchic tax system.

In many cases, especially for large corporations, economic sources of income have been replaced by tax sources of income.

People have been saying for years that "there must be a better way." There is a better way and that is the single rate business oriented Gross Income Tax or simply the GIT System. The GIT System would go to the basic source of all tax funds and that source is the business activity of the nation. Business activity is defined as the issuance of invoices or bills to a buyer and the payment of those invoices or bills to the vendor. These payments are the Gross Receipts of the vendor. That vendor's Gross Income is the Gross Receipts less the Cost of Goods sold. The GIT System would tax directly this Gross Income at a single rate which is estimated to be between 4% and 6%.

For the individual wage earner (IWE) there could be two ways of applying GIT.

One way would be to use the principal of allocation, see line 33 of the illustrative gross Income Tax Return (Exhibit 1). This would eliminate the filing of over 97 million form 1040 tax returns. The April 15 national trauma would no longer exist.

The other way would be to have IWE's file a return and pay the GIT rate similar to business returns. This would reduce the GIT rate by approximately 1%.

To those critics who say that GIT would cost many jobs of CPA's, tax preparers and tax lawyers, let them be reminded that GIT is a new technology. New technologies in the past -- the machine age; the industrial revolution; the computer age -- did not cost jobs. They only shifted emphasis on the way those jobs were being accomplished. Displacements were only temporary and many new types of jobs were created.

One of the reasons we need this new tax technology is that we are rapidly approaching an economic feudal state. In the middle ages the feudal fiefdoms were enforced by standing armies. Today's feudal fiefdoms are being enforced by economic power gained from our tax system. The GIT system would foster a return to a large middle class which has been the traditional strength of America.

There are a number of advantages to the GIT System.

FOR THE WAGE EARNER

1. No more filing of Form 1040.
2. Rates would be so low that special deductions like mortgage interest deductions would not be necessary.
3. No more fear of audits by the IRS.
4. Paying taxes would again become a source of pride instead of dread and disgust.

FOR THE BUSINESSES OF OUR COUNTRY

1. At least 90% of paperwork (dollars) now required for tax compliance would be eliminated. Business paperwork costs have been estimated at over $100 billion per year.
2. Business tax audits would be simple, direct and consume very little time.

FOR THE GOVERNMENT

1. Cash flow would no longer be a problem and the government could cease most of its borrowing activities.
2. At least 70% of the government's compliance and collection costs would be eliminated.
3. The GIT system is so powerful as a revenue producer it could reduce our

national debt in a short period with only a slight increase in the GIT rate.

An eclectic view of all the tax "reform" proposals put forth in the past few years should be profitable. A question and answer format would be most informative. In this format, the following listed abbreviations are used:

A. GIT -- The Gross Income Tax
B. FRT -- The Flat Rate Tax (Bradley/Gephardt; Kemp/Kasten; Quale; Siljander; Hall/Rabushka; etc.)
C. VAT -- The Value Added Tax
D. NST -- The National Sales Tax
E. DET -- The Dedicated Excise Tax
F. NIT -- The Net Income Tax
G. UCT -- The Uniform Consumption Tax (Based on Blueprints for Basic Tax Reform, Chapter 4)

I. HOW COMPLEX IS THE SYSTEM?

Answer:

A. GIT -- The GIT is extremely easy to administer for both the taxpayer and the government. Computerization is an easily accomplished method of keeping tax books. Yearly tax bookkeeping is no longer a traumatic experience. (See Exhibit V).

B. FRT -- The Flat Rate Taxes so far proposed such as Bradley/Gephardt, Kemp/Kasten, Quale, Siljander, and DeConcini, still have their roots in our present NIT system. Even though some simplification may be possible for a short time, it stands to reason, based on historical evidence, that they will all be amended to again resemble our present state of tax stagnation after a few Congresses have met.

C. VAT -- This is a complex tax that would require much record-keeping to determine the "value added." It is also a point-of-sale type of tax that would require a larger IRS.

D. NST -- This is a complex tax that would increase the size of the IRS because of the extra personnel required to audit the point-of-sale collection procedure. Complexity would also be increased because of the exemptions that would inherently accrue for items such as living necessities or business exemptions.

E. DET -- This tax could be easily collected and in fact is accomplished by the use of stamps (cigarettes, liquor) and through collection by vendors, such as the gasoline tax.

F. NIT -- This tax has a wealth of current empirical evidence that the system is so complicated as to preclude its further use as a practical vehicle for funding the government.

G. UCT -- The UCT is simply another varient of NIT and of course just as complicated.

II. HOW FAIR AND EQUITABLE IS THE SYSTEM?

Answer:

A. GIT -- The GIT is fair because it collects the tax directly from the source of all taxes -- the business activity of the country. There would be fewer entities involved in the collection process, hence opportunities for unfair treatment would diminish.

B. FRT -- The "flat rate" taxes share the same unfairness considerations as our present NIT system.

C. VAT -- The VAT would appear to be fair if it is conceded that there be no objections to its regressive nature.

D. NST -- The NST has always carried with it the historical criticism that it is regressive. However, state sales taxes have never had taxpayer resistance that property taxes and net income taxes have had. Probably the reason for this is that rates are relatively low when compared to other tax systems.

E. DET -- The DET is fair in the sense that only the receiver of government services pay the tax. It's a one-on-one relationship.

F. NIT -- The NIT is unfair and the unfairness has its roots in the very way the tax is structured. Assume that all companies in the country were rolled into just two large conglomerates, one of them made good acquisitions and had good management with good net profits every year, while the other was poorly managed and made very little net profits each year. The government now comes along and says, "Hey folks, we need $900 billion to operate on next year." It is self self evident that the profitable well-managed conglomerate is going to carry the tax load for the poorly managed conglomerate. This subsidization of poorly managed businesses by well-managed businesses is an everyday occurence in thousands of businesses on a smaller scale. It's the fundamental and monumental flaw of our NIT system.

G. UCT -- The UCT simply further narrows the tax base. The short fall must be made up by other taxpayers and is thus unfair. Another extremely unfair characteristic of the UCT is its regressiveness. A taxpayer who makes $50,000 per year with a $10,000 per year consumable expense has $40,000 left to save or invest tax free. A taxpayer who makes $500,000 per year with the same $10,000 consumable expense has $490,000 to save or invest tax free.

III. HOW ECONOMICALLY NEUTRAL IS THE SYSTEM?

Answer:

A. GIT -- The GIT is almost 100% neutral if no credits were allowed. If more below-the-line credits are legislated into GIT as the years pass, it becomes less neutral. However, credits cover a broader public purpose than above-the-line deductions, which are highly subjective and usually for special interest purposes. Credits also are more easily accounted for in our computerized society.

B. FRT -- The FRT has essentially the same neutrality characteristics as our present NIT system because the basis for the FRT is the same as NIT.

C. VAT -- The VAT does not have many neutrality questions associated with it. It is primarily a revenue-producer, and for the Congress to use it to change economic or social behavior would necessitate extraordinary legislative handsprings.

D. NST -- The same comments cover the NST as stated under VAT above.

E. DET -- The DET is one of the most non-neutral systems of all. Indeed, it is used many times as a punitive tax, i.e., tobacco and liquor taxes.

F. NIT -- The NIT is as non-neutral as the DET. However, the effect is more massive and with little control; witness the explosion of abusive tax shelters in the past few years.

G. UCT -- The UCT is essentially the same as the NIT in its non-neutrality with the additional provision that income that is invested or saved would not be taxed. This feature would open the door for a new era of money hording similar to that in the late 1920s and early 1930s.

IV. WHAT IS THE BASE OF THE TAX?

Answer:

A. GIT -- The base of the GIT is the business activity of the country. The source of all taxes is the paid invoices of the country's business operating entities (BOEs), both incorporated and unicorporated. The GIT has the broadest base of all the major tax systems.

B. FRT -- The Flat Rate Tax systems so far legislatively proposed have the NIT system as their respective bases.

C. VAT -- The VAT has as its base the value added to goods manufactured at each stage of production. Labor costs would be indirectly factored in through sales pricing. The VAT tax collection would stop at the wholesale level, unless VAT legislation would specifically include sales markups in a retail operation as "value added." Basically the VAT is a tax on the GNP.

D. NST -- The base of the NST would be the retail sales of the country. Traditionaly, state sales taxes are not collected on wholesale transactions.

E. DET -- The base of the DET is a selected commodity or group of commodities, usually for specific user purposes.

F. NIT -- The base of NIT is the net income of the BOEs, less any paper deductions, i.e., depreciation deductions. It has the narrowest beginning base of all the major tax systems except the UCT.

G. UCT -- The UCT has its base in the NIT except, that it does not tax that part of income that is not spent which narrows the base even more.

V. CAN THE TAX SYSTEM COMPLETELY REPLACE THE PRESENT NIT SYSTEM OR WILL IT BE AN ADDITIONAL NEW TAX SYSTEM?

Answer:

A. GIT -- The GIT can replace the present NIT system in its entirety. It can also replace the present social security payroll tax system with about a 4% increase in the GIT rate. If GIT were to be used to replace both the NIT and the payroll tax the rate would be from 7% to 9%.

B. FRT -- The FRT in one of its variations can of course not ever replace our present NIT system because they are derivitives of that system. To raise sufficient revenue, a supplementary tax like a VAT or a NST would have to be legislated.

C. VAT -- The VAT cannot replace our present NIT system because it is narrowly based on the GNP. It would have to be a new "helper" tax in addition to our present tax system.

D. NST -- The NST has the revenue-raising capability to replace the NIT, if it is properly implemented.

E. DET -- The DET cannot replace NIT but could be enhanced by the addition of more commodities or services. The ultimate in addition could approach the NST with special treatment of certain commodities.

F. UCT -- The UCT cannot replace the NIT because it is a derivative of NIT. In fact UCT, is a further narrowing of the base on a grand scale.

VI. HOW EFFECTIVELY DOES THE TAX SYSTEM ENABLE CONGRESS TO USE TAX EXPENDITURES FOR BROAD PUBLIC PURPOSES?

Answer:

A. GIT -- The GIT does not allow for any type of deductons or exclusions above-the-line. However, it does allow below-the-line credits. The major difference between the two types of expenditures are that deductions are subjective with a particular taxpayer, while credits cover a wider spectrum of classes of taxpayers. Credits have a strong kinship with direct grants. The Congress has better control of tax expenditures under GIT because of the open nature of such expenditures when credits are used.

B. FRT -- The FRT is based on NIT. NIT has been used for the last 70 years for all kinds of incentives (or disincentives) for both social and economical action. The bulk of that activity has occurred since the early sixties. The results are self-evident. The FRT is but another variation of the NIT.

C. VAT -- The VAT would be very difficult for the Congress to use for tax expenditures on any major scale. However, it could be used to affect certain industries, e.g., lower rates could favor the steel industry. Such usuage could result in an administrative maze as the years pass.

D. NST -- Much the same comments concerning the VAT are applicable to the NST.

E. DET -- The DET taxes that now exist have a highly selective use for social and economic effects, to relate them with respect to tax expenditures would entail their broad expansion until they would approach the NST as a tax force.

F. NIT -- The uses and effects of using the NIT for tax expenditures are historically self-evident. One of the all-encompassing tax expenditures is the allowance of above-the-line business deductions.

G. UCT -- The UCT is but yet another variation of the NIT. Its big tax expenditure is the exclusion from taxable income that part of income that is not spent on consumables.

VII. HOW EASY WOULD IT BE FOR THE TAXPAYER TO COMPLY WITH THE TAX AND WHAT WOULD EXPECTED PUBLIC ATTITUDES BE?

Answer:

A. GIT -- The GIT would eliminate much public (especially wage earners) contact with the paying process, but who would have complete knowledge of their contribution to the governments expenditures. This is accomplished by the allocation process, see Exhibit 1, Illustrative GIT Tax Return, line 32. For businesses the GIT would be much simpler to file and would eliminate the W2 form and its attendant headaches. Also, businesses that are computerized could deposit their tax liability on a daily (or other short term) basis and thereby discharge their tax responsibilities immediately. This would eliminate the expensive (and unproductive) year end trauma of tax return preparation.

B. FRT -- The FRT is again another variation of NIT and will carry all of the negatives of the present tax system.

C. VAT -- It would not be hard for the wage earner to comply because he or she would be in the process only to the extent of paying the tax in the commodity pricing process. The sellers would be saddled with an additional bookkeeping chore as well as their State sales tax chores.

D. NST -- Much the same comments concerning the VAT apply to the NST.

E. DET -- Most excise taxes today are collected via the stamp (cigarettes, liquor) or are included in the sales (gasoline) price. Even when they are punitive, there seems to be little public outcry.

F. NIT -- Our present tax system has an extremely poor public image. Sometime even violent behavior is exhibited. The Federal income tax has surpassed the property tax as the most unpopular tax.

G. UCT -- The UCT, as a variation of the present NIT, would probably be very unpopular because the public would regard it as the "rich man's" loophole.

VIII. WOULD THE TAX SYSTEM ALLOW AN INVASION OF PRIVACY?

Answer:

A. GIT -- The GIT would have a minimal privacy impact for businesses because the tax would be almost entirely cash-oriented. Peripheral issues such as entertainment expense or travel expense would no longer exist. For wage earners, the privacy issue would also be minimal to the extent that the Congress refrains from using the allocation process for social purposes.

B. FRT -- This variation of the NIT would have the same privacy problems as our present NIT system.

C. VAT -- There would appear to be no privacy problems with the VAT.

D. NST -- The same comments apply.

E. DET -- The DET exhibits no problems of privacy.

F. NIT -- Our present NIT system has large problems of privacy invasion. For wage earners, the tax returns and subsequent audits reveal, many times in detail, the lifestyle and personal work details that under normal circumstances would be private matters. For businesses the privacy issue is minimal for large companies but increases as the company size decreases. Small proprietorships are but a small step removed from the wage-earner concept.

G. UCT -- This variation of the NIT has the same privacy problems as the NIT.

IX. UNDER THE TAX SYSTEM WHAT IS THE GOVERNMENT'S ABILITY TO EFFECT COLLECTIONS AND TO AUDIT ACCOUNTS?

Answer:

A. GIT -- Collections under the GIT would be made by the BOE directly from the source -- the business activity of the country. Transmittal of the funds could be simply made by electronic or manual transfer on any periodic basis from 1 day to 1 year or any period in between. Audits would be made simply by examining bank accounts and the few papers that would account for tax credits. Long, drawn-out audits would no longer be necessary.

B. FRT -- Collection and audit procedures under FRT would be the same as NIT.

C. VAT -- The VAT does not have the revenue-producing ability to replace the NIT. Therefore, additional collection and enforcement would have to be added to the IRS. The number of personnel added could be large because of the point-of-sale nature of the tax system.

D. NST -- The NST has the revenue-producing capability to replace the NIT. If it did, our tax collections and enforcement mechanism would be changed drastically. There should be relatively few problems for the Government.

E. DET -- The DET would have few problems in collection and enforcement. The government has current experience in this area.

F. NIT -- The ability of the government to enforce and collect taxes is historically documented.

G. UCT -- This variation of the NIT would introduce new measures for collection and enforcement by having to monitor millions of savings and investment transactions as well as having millions of borrowing/lending transactions.

X. WOULD THE TAX SYSTEM BE PROGRESSIVE OR REGRESSIVE?

Answer:

A. GIT -- The question of progressivity or regressivity under the GIT is Moot because the tax is collected by the Nation's businesses directly from the source (business activity) and is then transmitted directly to the government.

B. FRT -- The same problems of progressivity or regressivity exist under FRT as under NIT. Progressivity does increase as loopholes are closed and some of the FRT proposals incorporate some loophole closing.

C. VAT -- The VAT would be regressive because the VAT would be factored into the final consumer price. Since a higher percentage of lower income taxpayers spend money on consumable goods, the tax burden falls on them more heavily.

D. NST -- The NST, like all sales taxes, are recognized as being regressive.

E. DET -- The DET is a broad-based use tax that cuts across all income classes and is not usually considered regressive.

F. NIT -- The NIT is highly regressive. This regressivity decreases almost linearly with an increase in taxpayer income. Actual degree of linearity depends on a taxpayer's investment program.

G. UCT -- The same problems with respect to regressivity under UCT are the same as exists under NIT.

XI. HOW WELL DOES THE TAX SYSTEM RELATE TO OR TRACK THE ECONOMY?

Answer:

A. GIT -- The GIT tracks the economy in an almost one-to-one relationship. If the Nation's business activity increases 1% and the GIT tax rate is 5%, then the increase in tax revenue is 0.05%. The degree of aberration from this would be the aggregate amount of tax credits being extracted from the economy.

B. FRT -- Because the FRT is a derivative of the NIT, there is only an amorphous relationship between the economy and the tax revenue.

C. VAT -- The VAT would have a relatively good relationship with the economy. The degree of aberration would depend on current ratios of the production of goods to the production of services.

D. NST -- The NST would track the economy very well depending on how many exemptions or exclusions were allowed.

E. DET -- The DET would hardly track the economy at all, the reason being the relatively small percentage of excise tax sales to total sales.

F. NIT -- Because the empirical evidence is abundant with respect to our current tax system, it is evident that NIT does not track the economy except in an amorphous way.

G. UCT -- The same problems with tracking the economy under UCT are the same as exist under NIT.

XII. WHICH TAX SYSTEM WOULD ALLOW THE EASIEST TRANSITION?

Answer:

A. GIT -- The GIT tax return would be simple and easy to prepare for businesses. It is estimated that only 10% of the paperwork required for NIT would be required for GIT; for wage earners 100% of the paperwork would be eliminated under the allocation process. With this vast diminution of preparation costs, it would be practical to run parallel systems for a specified period, say 5 years (Exhibit II).

B. FRT -- Since the FRT is a variant of NIT, there is no transition problem. Transition simply resolves itself into the traditional amendment processes that have been enacted to change the 1954 Code ever since that Code became public law.

C. VAT -- There are no transition problems with the VAT because it does not have the capability to replace the NIT system. There would be problems of staffing and organizing a new function for the IRS.

D. NST -- There would be no transition problems if NST were conceived as a tax supplementary to the present NIT. Similarly to VAT, there would be staffing and organization problems for an additional function of the IRS.

E. DET -- Because the DET would not have the capability of replacing NIT, there are no transition problems. There would be problems of upgrading and increasing the scope of present IRS activity.

F. NIT -- Transition problems are not applicable.

G. UCT -- Because the UCT is a variant of NIT, there are no transition problems. The problems would be the traditional amendment problems in changing the 1954 Code.

XIII. WHAT WOULD BE THE PAPERWORK TAXPAYER IMPACT AND THE CONSEQUENT IMPLICIT TAXATION?

Answer:

A. GIT -- Paperwork for businesses would be cut by an estimated 90%, thereby cutting the present implicit taxation by a proportional amount.

B. FRT -- Paperwork and implicit taxation would remain about the same as now because the FRT is a NIT derivative.

C. VAT -- There would be an increase in implicit taxation under the VAT, perhaps as much as 25%.

D. NST -- There would be an increase in implicit taxation under the NST if NST were not conceived as a replacement for NIT. If it were legislated to replace NIT, there would be a diminution of paperwork and implicit taxation.

E. DET -- There would be an increase in paperwork in direct proportion to the commodities added to the excise tax base.

F. NIT -- The paperwork and implicit taxation of the NIT has increased steadily since 1913. There was an explosion of paperwork requirements, starting in the mid-sixties, which has continued until the present, culminating with the Deficit Reduction Act, PL 98-369. Thus, it is reasonable to assume that this implicit taxation will continue as long as the NIT is retained.

G. UCT -- The same remarks apply to the UCT as apply to the NIT above.

XIV. WHAT WOULD BE THE ADMINISTRATIVE EFFICIENCY OF THE TAX SYSTEM FOR BOTH THE TAXPAYER AND THE GOVERNMENT?

Answer:

A. GIT -- For the government, administrative efficiency should increase on the order of 70%. An OMB report in 1976 noted that of all paperwork generated by the government, 76% was generated by the Federal tax collection mechanism. Since that time, other reports have given figures down to 54% for tax paperwork. Prima facie evidence suggests a decrease in administrative efficiency with passage of the ERTA, TEFRA, and Deficit Reduction Acts since 1976. If the allocation process is used, the paperwork for the wage earner should decrease by at least 98%.

B. FRT -- Because the FRT has its basis in NIT, which is in turn based on the 1954 Code, there is no reasonable cause to believe that there will be any increase in administrative efficiency for either the government or the taxpayer. The continuing result will be burgeoning electronic file drawers (EDP) to match up billions of pieces of paper.

C. VAT -- Administrative efficiency of the VAT for the government would be quite low because of the subjective nature of the tax. Audit procedures would be extensive and involved. Administrative efficiency for the taxpayer could be relatively simple depending on how the "value added" is calculated and what components of selling prices are allowed.

D. NST -- The same remarks applying to the VAT would apply to the NST.

E. DET -- The administrative efficiency of the DET has been basically established. With increased DET activity, refinements may be necessary because of sheer volume.

F. NIT -- Administrative efficiency of the NIT has been established. Further expansion of NIT requirements with each passing Congress suggests that administrative efficiency will further decrease.

G. UCT -- The same remarks for the FRT would essentially apply to the UCT.

In conclusion it would seem that everyone who is studying our present tax and budget dilemma would examine such questions as stated above in great detail and not resort to rhetorical presentations about theoretical "distortions," "economic pressures," etc.

Now is the time for the nation to return to normal entrepreneurship on an economic basis. Let the tax system do its job, and that is to raise revenue.

EXHIBIT I

This ID number would cover every taxpaying entity, whether a corporation, division of a corporation, a professional investor, or an individual operating as a free enterpriser.

By paying an income tax on its gross income, a business operating entity (BOE) avoids the massive overhead costs associated with seeking deductions and other tax avoidance devices. Once a BOE files this return and pays the tax due, it can spend the remainder of its receipts any way it chooses. Thus, under GIT, businesses could operate freely on an economic basis rather than on a tax-consequent basis.

BUSINESS GROSS INCOME TAX RETURN

Name ______ Type of Business Operating Entity (BOE) ______ ①
Address ______ City ______ State ______ Zip ______ ②
Taxpayer Number ______ Period of Return: From ______ to ______ ③

Gross Receipts

Sale of Goods ______ $ ______ ④
Sale of Services ______ ______ ⑤
Sale of Combination of Goods and Services ______ ______ ⑥
Rentals of Real Estate ______ ______ ⑦
Sale of Real Estate ______ ______ ⑧
Rentals of Other Chattels ______ ______ ⑨
Dividends from Stocks ______ ______ ⑩
Sale of Stocks ______ ______ ⑪
Interest from Bonds ______ ______ ⑫
Sale of Bonds ______ ______ ⑬
Interest Received on Loans ______ ______ ⑭
Interest Received on Savings Accounts ______ ______ ⑮
Inheritances (market value) ______ ______ ⑯
Gifts (market value) ______ ______ ⑰
All other Income not reported above ______ ______ ⑱
Salaries or Wages (report only amounts received above $50,000.00) ______ ______ ⑲
Total Gross Receipts $ ______ ⑳
Cost of Sales $ ______ ㉑
Gross Income (Line 20 Less Line 21) $ ______ ㉒
Gross Tax (5% Times Line 22) $ ______ ㉓

Credits

Investment ______ ______ ㉔
Employment ______ ______ ㉕
Export Sales ______ ______ ㉖
Other Approved Credits ______ ______ ㉗
Total Credits $ ______ ㉘
Total Tax (Line 23 Minus Line 28) $ ______ ㉙

Total Wages Paid to Employees (IWE) for Year of Return $ ______ ㉚
Total Number of Employees (IWE) ______ ㉛

FOR IRS USE ONLY

Allocation for Employees Tax Contribution $ ______ ㉜
Allocation for FICA $ ______ ㉝
Allocation for Health Care $ ______ ㉞
Allocation for General Revenue $ ______ ㉟

Sufficient income from any of these sources would make an individual wage earner (IWE) a BOE for tax purposes.

Under the GIT system, income from inheritances and gifts would be taxed at the same rate as all other forms of income. There would be no additional tax burden, as there is under the present system.

This section may be used to promote any social or economic goals deemed advantageous for the Nation.

The information in this section would be used to determine employee allocations for Federal income tax, FICA, and any other funds designated by Congress. This information would be broken down by individual employee on a separate form, to account for partial years of employment, overtime, and raises. It is this second form that the IRS would use to allocate individual employee contributions. Once allocated, the IRS would then inform each employee of the amounts they paid into each fund.

The IRS would specify in this section the total allocation for all employees to each fund designated by Congress. The allocation percentages would be monitored closely by Congress and would be changed yearly, as needed.

This consecutive 12-month period will vary from one BOE to another. By staggering BOE tax reporting and payment dates throughout the year, the GIT system would preserve the Government's cash flow while eliminating interest-free Government borrowing.

This line provides for those cases where an employee earns far in excess of what could be considered fair wages for ordinary manual or mental input. Any employee who earns more than $50,000 per year (or whatever limit Congress sets), and who is thus engaged in the "sale of expertise," would be considered a BOE.

Because GIT would vastly broaden the tax base, the actual rate of taxation required to generate sufficient revenue for the Government would be very low. It is estimated that the tax rate would be from 4½% to 7½%.

This section would:

1. Eliminate the need for making out billions of W-2 forms (and related support paperwork) by all BOE's (Business Operating Entities) in the country.
2. Eliminate millions of income tax returns by individuals each year.
3. Finance the Social Security Program out of the same funds from whence it now comes, but by a more direct and less costly route. These funds are the gross income which a BOE uses to pay his share and also the wages from which the IWE pays his share. It all comes from the same pot.
4. Give our Congress complete control and efficiency in operating any social system which must be separately funded.

This illustrative GIT return when plotted on a mathematical basis follows the form.

$$y = mx \pm b_1 \pm b_2 \pm \ldots b_n$$

where,

y = Revenue (Yield) (line 29)
m = Tax Rate (line 23)
x = Gross Income (line 22)
b_1, b_2 = Tax Expenditures (Credits) (lines 24 thru 27)

The major advantage of the GIT system is that this Straight Line (Flat Rate) formula can be easily computerized. Consequently the Internal Revenue Service could furnish the Congress and the Executive branch with fast printouts of the results of any changes made. With such immediacy of response remedial decisions could be made on an informed basis.

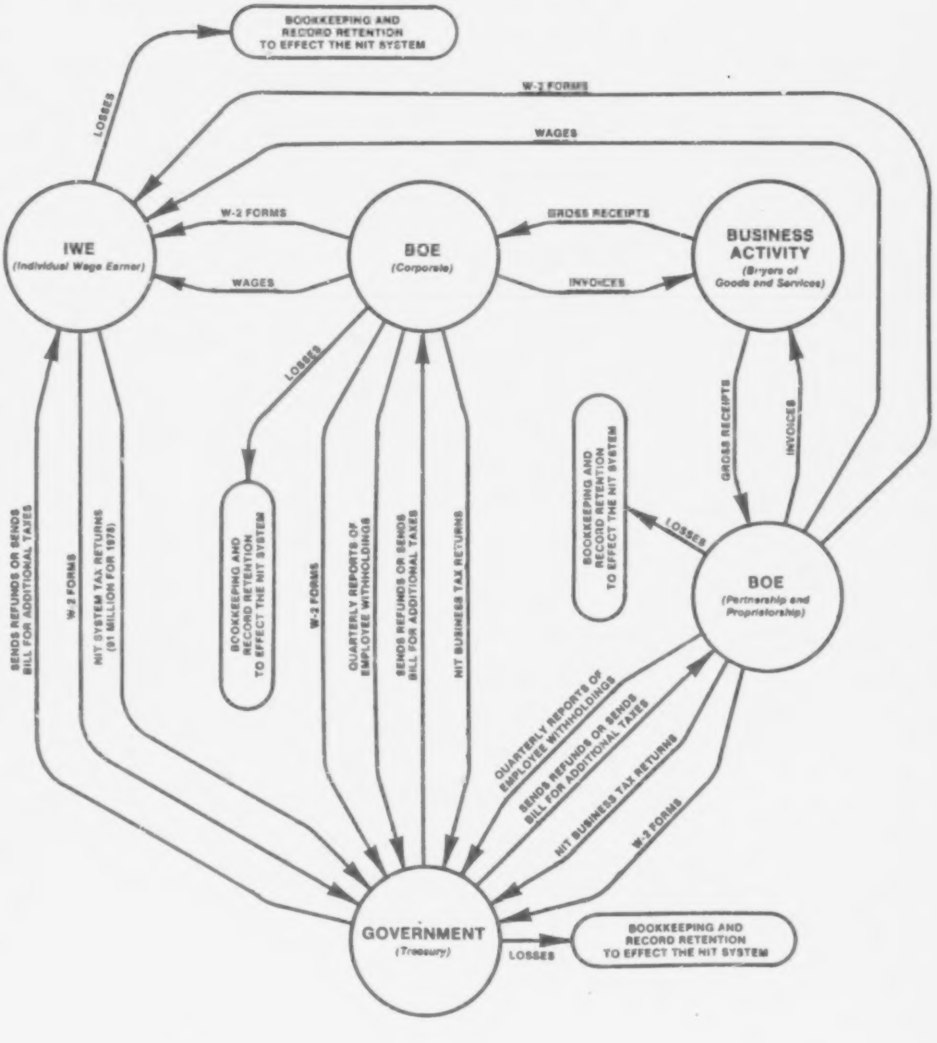
REVISED 7-1-82

EXHIBIT II

TRANSITION PROCESS FROM THE NET INCOME TAX (NIT) SYSTEM TO THE GROSS INCOME TAX (GIT) SYSTEM BY USING PARALLEL SYSTEMS

1. Legislate the gross income tax (GIT) system.
2. Let the legislation indicate the starting dates, to be either the next calendar year or the next fiscal year, as elected by the taxpayer.
3. On the starting date the taxpayer will file two returns: (A) a GIT return and (B) a NIT return.
4. Let the legislation indicate a beginning GIT rate of 1%.
5. After the first year let the GIT rate increase by 1% for each succeeding year.
6. Let the legislation provide for a credit to the NIT return in an amount exactly equal to the liability under the GIT return.
7. For each succeeding year repeat the process until the GIT revenue equals the NIT revenue before the GIT credit to the NIT return is applied.
8. Let the legislation indicate that any established business may elect to go to 100% GIT tax filing at any time.
9. Let the legislation indicate that all new businesses whether incorporated or not must file by the GIT method.

EXHIBIT III

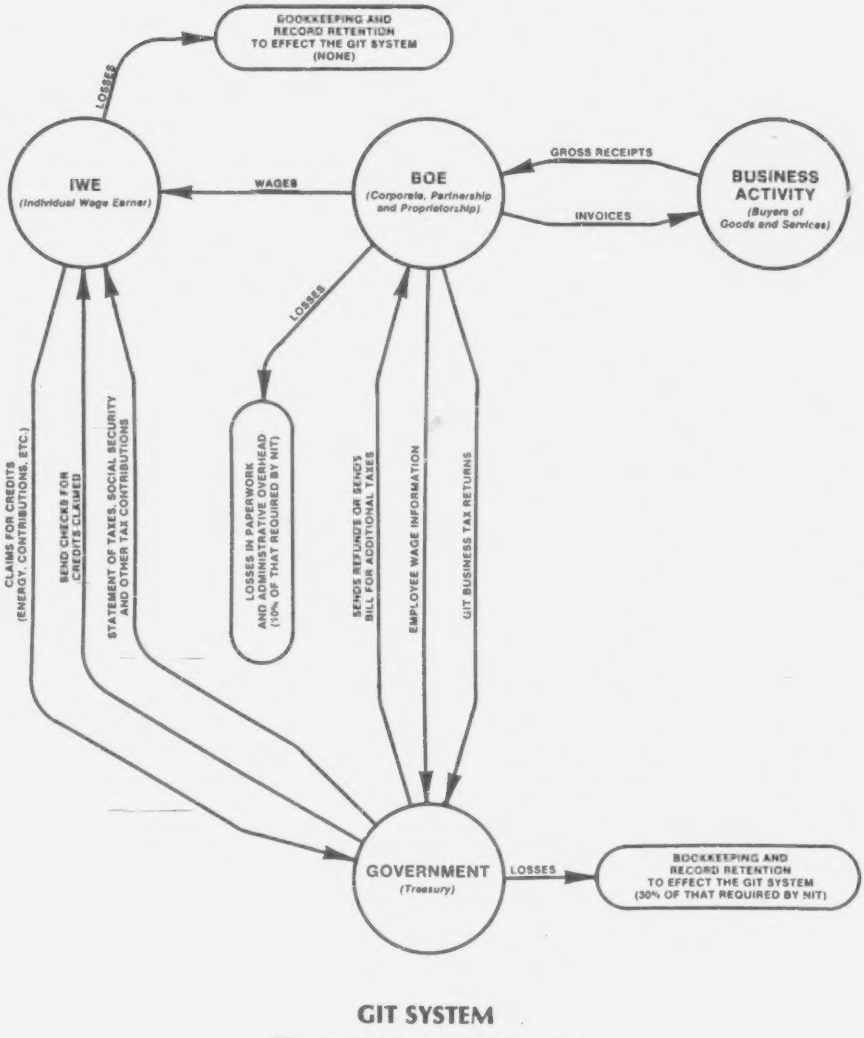

BOOKKEEPING AND
RECORD RETENTION
TO EFFECT THE NIT SYSTEM
LOSSES
W-2 FORMS
WAGES
IWE
(Individual Wage Earner)
W-2 FORMS
WAGES
BOE
(Corporate)
GROSS RECEIPTS
INVOICES
BUSINESS
ACTIVITY
(Buyers of
Goods and Services)
LOSSES
BOOKKEEPING AND
RECORD RETENTION
TO EFFECT THE NIT SYSTEM
GROSS RECEIPTS
INVOICES
BOOKKEEPING AND
RECORD RETENTION
TO EFFECT THE NIT SYSTEM
LOSSES
BOE
(Partnership and
Proprietorship)
SENDS REFUNDS OR SENDS
BILL FOR ADDITIONAL TAXES
W-2 FORMS
NIT SYSTEM TAX RETURNS
(91 MILLION FOR 1978)
W-2 FORMS
QUARTERLY REPORTS OF
EMPLOYEE WITHHOLDINGS
SENDS REFUNDS OR SENDS
BILL FOR ADDITIONAL TAXES
NIT BUSINESS TAX RETURNS
QUARTERLY REPORTS OF
EMPLOYEE WITHHOLDINGS
SENDS REFUNDS OR SENDS
BILL FOR ADDITIONAL TAXES
NIT BUSINESS TAX RETURNS
W-2 FORMS
GOVERNMENT
(Treasury)
LOSSES
BOOKKEEPING AND
RECORD RETENTION
TO EFFECT THE NIT SYSTEM

NIT SYSTEM
ADMINISTRATIVE WORK FLOW

Figure A

Revised 6-1-81

EXHIBIT IV


BOOKKEEPING AND RECORD RETENTION TO EFFECT THE GIT SYSTEM (NONE)
LOSSES
IWE
(Individual Wage Earner)
WAGES
BOE
(Corporate, Partnership and Proprietorship)
GROSS RECEIPTS
INVOICES
BUSINESS ACTIVITY
(Buyers of Goods and Services)
LOSSES
LOSSES IN PAPERWORK AND ADMINISTRATIVE OVERHEAD (10% OF THAT REQUIRED BY NIT)
CLAIMS FOR CREDITS (ENERGY, CONTRIBUTIONS, ETC.)
SEND CHECKS FOR CREDITS CLAIMED
STATEMENT OF TAXES, SOCIAL SECURITY AND OTHER TAX CONTRIBUTIONS
SENDS REFUNDS OR SENDS BILL FOR ADDITIONAL TAXES
EMPLOYEE WAGE INFORMATION
GIT BUSINESS TAX RETURNS
GOVERNMENT
(Treasury)
LOSSES
BOOKKEEPING AND RECORD RETENTION TO EFFECT THE GIT SYSTEM (30% OF THAT REQUIRED BY NIT)

GIT SYSTEM

ADMINISTRATIVE WORK FLOW

Figure B

Revised 8-1-81

EXHIBIT V

TAX EQUATION

Any income tax system equation takes the traditional mathematical form:

$$y = m(x - a) \pm b \qquad \text{EQUATION 1}$$

This is a straight line function if m is a constant. Thus it is the equation form for the "Flat Rate" tax, if it is a true flat rate. If m is a constant within certain brackets or segments and the segments intersect or are connected end-to-end, then it represents a tax system with constant rates m1, m2 - mj where j represents the last bracket. In our present NIT system we have 16 such ms or brackets, the Bradley-Gephardt and Kemp/Kasten proposals have 3 ms or brackets. The other across-the-board flat rate proposals have only one m or bracket. The GIT would have only one m or bracket but the base would be different.

If we now put equation into tax parlance the equation would look like this:

$$R = r(t - d) \pm nc \qquad \text{EQUATION 2}$$

Where:

R = Revenue yield or taxpayer liability
r = Tax rate
t = Tax base
d = Aggregate deductions, both economic and legislated
c = Credits or surcharges
n = Rate allowed on the base of the credit

If we expand equation 2 we have

$$R = rt - rd \pm ne \qquad \text{EQUATION 2a}$$

Everything to the left of the ± sign in equation 2a is an above-the-line deduction. Everything to the right of the ± sign is a below-the-line credit.

It can be easily seen that the deductions (d) are operated on by the tax rate. Thus under our NIT system a high bracket taxpayer gets a higher effect from above-the-line deductions than does a low bracket taxpayer.

Below-the-line credits on the other hand are not affected by general tax rates. The n (rate) may be arbitrarily assigned to fit a specific economic purpose.

The application of equation 2 to the GIT tax return (Exhibit I) is as follows:

R = Tax liability (line 23)
r = Tax rate (line 23)
t = Tax base (line 22)
c = Applied credits (line 21)

EXHIBIT VI

GLOSSARY

ABOVE-THE-LINE -- refers to economic deductions, exclusions and preferences above the profit and loss line. It also refers to legislated paper deductions, i.e., depreciation.

BELOW-THE-LINE -- refers to tax credits, surcharges and sometimes exemptions, i.e., a base exemption of a given dollar amount for the protection of low income wage earners or starting entrepreneurships.

BOE -- Business Operating Entity. It includes all forms -- corporations, proprietorships, cooperatives, etc.

IWE -- Individual Wage Earner.

IMPLICIT TAXATION -- Implicit Taxation is the cost of complying with a tax system.

OMB -- Office of Management and Budget.

IRS -- Internal Revenue Service.

COST OF GOODS SOLD -- This is defined as direct product input. For manufacturers this would include the raw materials or components which are incorporated in the finished product. For resellers this would be the wholesale price of the goods to be resold.

Senator **Packwood**. Mr. Oswald, let me ask you, what is your definition of a consumption tax? The term is used frequently, and I just want to make sure everybody is talking about the same thing.

Mr. **Oswald**. By a consumption tax, I would mean one that taxed that money which people spent for goods and services and would exempt from taxation that money that people received and did not use for domestic spending for goods and services.

Senator **Packwood**. All right. Would the liquor tax be a consumption tax?

Mr. **Oswald**. Yes, sir.

Senator **Packwood**. Cigarette tax?

Mr. **Oswald**. Yes, sir.

Senator **Packwood**. Gasoline tax?

Mr. **Oswald**. They are all a specific type of consumption or excise taxes, yes, sir.

Senator **Packwood**. And the old tax that we had on tires and tubes?

Mr. **Oswald**. Were, also.

Senator **Packwood**. Telephone tax?

Mr. **Oswald**. In some cases, Senator, I would differentiate between different types of consumption taxes. Some of these might be particularly related to what I would call user taxes, particularly something like the tire tax, particularly as it applied to trucks. It was a type of tax that was raised to pay for highways and highway funds.

I would differentiate between a user tax, where there is money earmarked in terms of taxation of the people who specifically benefit from a product, versus a general consumption tax.

Senator **Packwood**. Liquor and cigarette taxes would be general consumption taxes, as that isn't earmarked?

Mr. **Oswald**. That's correct.

Senator **Packwood**. Now, would this also be a fair definition? "A consumption tax is a tax that is by and large passed along to everybody who has to buy the product, and the rich and the poor pay the same tax, regardless."

Mr. **Oswald**. Well, they pay the same tax regardless of their ability to pay the tax.

Senator **Packwood**. Yes. If you were making $5,000 a year or $500,000 a year, and you buy a bottle of Jim Beam, you pay the same tax.

Mr. **Oswald**. That is correct.

Senator **Packwood**. If you buy a package of Camels, you pay the same tax.

Mr. **Oswald**. That's correct.

Senator **Packwood**. Now let me ask you about the windfall profits tax on oil. Is that a consumption tax?

Mr. **Oswald**. There have been arguments in that respect. I would argue that it is not, that it is a profit on the tax itself.

Senator **Packwood**. It is a what?

Mr. **Oswald**. On the profits, and it is not passed on to consumers.

Senator **Packwood**. Well, let me back up. You are not saying that the windfall profits tax is a tax on profits.

Mr. OSWALD. It is a tax on the profits that oil firms have been able to achieve as the result of the change of the deregulation of gas.

Senator PACKWOOD. I don't think so. And Senator Long can correct me if I'm wrong on this, because he knows oil taxation better than I do.

The windfall profits tax is an excise tax on oil as it comes out of the ground, and you pay it whether or not your company makes a profit.

Mr. OSWALD. But it was based upon the decontrol of gasoline prices. It was established on the basis that the cost factors that were allowed to be the determination of the price of gasoline prior to decontrol were being removed, with the expectation that the removal of those price controls would result in large increases in profits to corporations, and that the excess profits tax thus was a tax on that expected increase in profits resulting from deregulation.

Senator PACKWOOD. Let me ask it in another way. I remember what we hoped. We knew that when we deregulated oil there might be increases in profits. The windfall profits tax is an excise tax on oil as it comes out of the ground. We hoped that the companies would eat it rather than pass it on.

Mr. OSWALD. That's correct.

Senator PACKWOOD. If they don't, it's a consumption tax, isn't it?

Mr. OSWALD. If it is passed on, it is a consumption tax. If it is not passed on, it is a profits tax.

Senator PACKWOOD. Would the AFL-CIO support an expansion of the windfall profits tax?

Mr. OSWALD. At this particular point we have not made a proposal, as you look at our detailed proposal, on the windfall profits tax. We think that there needs to be detailed studies in the whole energy area, and we are not at all sure that the mixture that we have today on both oil and natural gas decontrol is the best means of dealing with our energy and our tax system as it interrelates to support of energy independence for this country.

Senator PACKWOOD. Well, we are gradually moving down the road toward total deregulation of natural gas; as your older gas runs out, as we find more gas under 15,000 feet, you are going to have more and more deregulation of gas.

Do you think the AFL-CIO would support a windfall profits on energy generally, not just on oil but on energy generally?

Mr. OSWALD. Senator, you can't separate the various taxes as they affect energy. There are depletion allowances, the exemptions for stripper wells, and others. In terms of looking at the taxes of oil companies they are among the lowest payers of tax currently in our total corporate side, in terms of percentage of their profits that are paid in tax—and I think that needs to be addressed in the revamping of the corporate income tax.

Senator PACKWOOD. Well, let me pose this last question. My time has run out.

Senator Long correctly, 2 days ago, indicated that the only reason the windfall profits tax does not get passed along is not because of the profits or lack of them with the oil companies, it is because the price of oil is set by the world market. And indeed it is set by the world market. And to the extent that the OPEC countries at the moment are in a bind with a surplus of oil and oil prices are down, obviously American companies cannot charge more for their oil than we can buy it imported.

Have we, at the same time, imposed and oil import fee in addition to the windfall profits tax, that tax would have been passed along.

Mr. OSWALD. We have not supported an oil import fee, Senator.

Senator PACKWOOD. You did in 1978, as I recall, in conjunction with the windfall profits tax.

Mr. OSWALD. At that time. But we have not supported that in isolation nor in the 1982 tax bill.

But I think to talk about oil as being set by market forces is stretching things. They certainly aren't free market determined. They are heavily affected still by the power that continues to exist in OPEC and are certainly influenced by a fairly small number of very large, dominant firms that operate internationally.

Senator PACKWOOD. I didn't mean to say that they were free market. I'll just make you this bet: If OPEC raised the price of oil to $40 a barrel, our domestic companies would raise the price of domestic oil to $40 a barrel.

Mr. OSWALD. Most likely.

Senator PACKWOOD. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Long?

Senator LONG. No questions.

The CHAIRMAN. Senator Symms?

Senator SYMMS. Thank you very much, Mr. Chairman. And I appreciate all of the witnesses who testified here today and your points of view on things.

I've got several questions I would like to ask, Mr. Chairman, and I want to ask a couple of quick ones, if I can, to Mr. Jones. Senator Grassley had to be on the floor; he wanted to be here to ask some of these questions.

First, I want to ask Howard Phillips a question: Howard, you are backing the flat-10 proposal, and I've got a breakdown sheet here on it that says, "Flat 10 makes no revisions to the current corporate tax system."

I haven't had the chance to talk to Congressman Siljander about this, about what he perceives would happen. I happen to tend to think most people get more Government than they can afford, anyway, and we always say thank God we don't get all we pay for or everybody would be out of business.

But the point I want to get at is, in a State like I come from where corporations provide the jobs—say, the paper companies, that would be a good example, or the people who work there—if we go to the flat-10 tax, you know there is going to be a dramatic drop in revenue by looking at that, because you keep basically the major deductions in it. What do we do, then, raise the corporate tax to make the difference?

Mr. PHILLIPS. No, I would not personally raise the corporate tax; I can't speak for Congressman Siljander.

Let me say that Fortune Magazine several weeks ago did a comparative analysis of some of the principal proposals—including Siljander, Kemp-Kasten, Bradley-Gephardt—and it was the opinion of the author that there would be a $20 billion revenue loss in the first year of the Siljander plan. I don't know.

I know that OMB and CBO have never——

Senator SYMMS. Right. Well, OMB would probably say $250 billion. And they might be close.

Mr. PHILLIPS. They would be hard put to say that, Senator, with respect. If you look at the fact that in 1984 the total amount of money collected from the individual income tax was only $293 billion. So I very much doubt that it would knock out 80 percent of that.

Senator SYMMS. Right. Well, that's a good point. You know, there would be some money that would come out of the woodwork from people who are just trying to stay in the underground economy right now.

Mr. PHILLIPS. If there were a dynamic model, there are people who argue that there would be higher revenue levels.

Senator SYMMS. I don't disagree with your basic philosophical premise or that of Paul Craig Roberts, from the philosophical standpoint that it might put the role of the individual and the State back in perspective. I'm not sure it is realistic at the present time to get that done, but I just think there is something there that I would urge you to take a very careful look at, that those Western or any resource-producing State where, say, mining is a big industry, and the cash flow of most mines comes from investment tax credits, about half of it today, what would happen to those corporate taxes? As the people here in Washington would say, "Now, we've got a worse deficit than we had before," in that lag time.

Mr. PHILLIPS. Senator, let me say that both Congressman Siljander and the Conservative Caucus have endorsed the concept of a spending freeze in terms of across-the-board totals, without prejudice to the priorities within the overall totals.

Senator SYMMS. I understand.

Mr. PHILLIPS. And I would simply reemphasize that if we had had such a freeze at the fiscal year 1980 level, with our present level of revenues we would have a budget surplus greater than $200 billion annually.

Senator SYMMS. Thank you very much.

Jim, before I ask you these questions that Senator Grassley wanted to have asked and that I am happy to ask, because I want to know the answers, too, I just wanted to make an observation to Rudy that there is an article in the Wall Street Journal, 2 days ago, by Bill Dutcher from Norman, OK. I am sorry I don't have a copy of it, but he is backing Mondale this year because they deregulated the price of oil and it went down for the consumers. He said he wants a President that is anti-oil company so he can afford to stay in the business, that they can't stand all that competition. That kind of ties in with Senator Packwood's point.

And I agree with Senator Long—you can't pass this cost on in an international commodity. The companies have to eat it. And prices are going down.

But Jim, what's the base of the tax, and why are the projected rates of your GIT tax so low?

Mr. JONES. Well, the base is the business activity of the country. It is calculated by taking the gross receipts—it's a business-oriented tax—taking the gross receipts, subtracting cost of sales, which gives you gross profit or gross income.

Senator Symms. Would most corporate taxes go up or down under this?

Mr. Jones. I think most corporate taxes would go down. However, that's hard to tell, because many large corporations don't pay any taxes at all; some of them even have negative rates. So their taxes may go up.

But we are bracketed in with a 4 to 6 percent, so I don't think there would be much objection to that.

Senator Symms. What are the distributional effects of the gross income tax? And then I will quit asking questions.

Mr. Jones. Well, the distributional effects of our present tax system are caused by the tax system itself. We have so many labyrinthine ways of getting money to the Government that comes from the business activity, until we have legislated in a number of distributional defects.

But by taking it directly from the business activity and then directly to the Government, using the businesses as a collection agency, you don't have—it just disappears.

Senator Symms. Thank you. My time is up.

I would like to ask unanimous consent, Mr. Chairman, to present Mr. Jones with these other four questions. Maybe he could answer them for our record.

The Chairman. Right. If you could do that, Mr. Jones, just supply the answers for the record?

Mr. Jones. Yes, I would be glad to.

[The questions from Senator Symms to Mr. Jones follow:]

Question. Can the gross income tax be a replacement of the current tax system or would it be an add-on helper tax?

Answer. The G.I.T. would be a complete replacement for the N.I.T. It could replace our present system with a G.I.T. rate of 4% to 6%. In addition, it could replace both the N.I.T. and the payroll tax with a G.I.T. rate of 7% to 9%.

Question. How would the problem of transition from the current system to the gross income tax system be addressed?

Answer. This would be accomplished by operating parallel systems for a specified time period, say 5 years. At the beginning the G.I.T. system would be legislated and operated at a rate of 1% while retaining the present N.I.T. system. Taxpayers would file both returns, however, the taxpayer would take a direct credit on the N.I.T. return for the liability incurred on the G.I.T. return; hence the two system operation would be revenue neutral. Each year the G.I.T. rate would increase by 1%. At the end of 5 years the G.I.T. rate would be 5% and should be enough to finance the government. See exhibit II of the prepared testimony.

Question. Would the gross income tax administratively be more efficient than our current system?

Answer. It would be much easier to administer for three (3) basic reasons, (1) over 97 million 1040 tax returns for wage earnings would be eliminated, thus removing the need for approximately 2 million audits each year. (2) The withholding system would be scrapped along with its billions of pieces of paper and the attendant costs, and (3), audits would be simple and would be carried out at the business level, with both the I.R.S. and the business taxpayer participating on a professional level.

It is estimated that government cost would be reduced by 70%; wage/earner by 95%and business operations by 90%.

Question. What would expected public attitudes be toward the gross income tax?

Answer. G.I.T. would remove the national trauma which comes once each year (usually April 15th) but which continues as the hapless/taxpayer anticipates the possible audit. In short, American citizens would again be able to pursue life, liberty and individual happiness.

The Chairman. Senator Bradley.

Senator **Bradley**. Thank you, Mr. Chairman.

I would like to ask Mr. Oswald: There is a lot of talk about what kind of taxes, and whether there should be tax increases next year. And one of the suggestions is that we have a national sales tax. From your perspective, what is right or wrong with a national sales tax?

Mr. **Oswald**. Senator, we believe that a national sales tax is wrong because it taxes those people who can afford it least, and it taxes·those people heavier because, in proportion to what they have, they have to spend all their money for the necessities of life. And those people who have more money, who may go abroad to spend part of their money, those who may go jetting around the world would escape from taxation on that part, and those with very large amounts of income, who could afford to pay more for the needs of our country, would not be paying more. Thus, it would be a disproportionate impact upon the poor, the workers.

Senator **Bradley**. Another suggestion that has been made is a value-added tax. What is right or wrong with a value-added tax?

Mr. **Oswald**. A value-added tax is just, in essence, a hidden sales tax, and it does raise many more elements in terms of administration—it is much more difficult to administer than a sales tax—and it implies somehow that it is not being put on individuals in the same way that a sales tax is.

We believe that there is no value in hiding a tax. If we are going to put on a tax, people should be aware of where the taxes are coming from and where they are going. We see no value in a value-added tax.

Senator **Bradley**. Is it correct to say that your basic assessment is that either a sales tax or a value-added tax would be detrimental to middle-income and low-income people?

Mr. **Oswald**. That is correct, Senator, because it taxes those proportionately higher than an income tax does, and it has no graduation at all in terms of reference to ability to pay.

Senator **Bradley**. And might I interpret what you just said to mean, in a simplified example, that if a wage earner earned $10,000 or let's say $20,000, and there was a 5-cent national sales tax that increased the cost of food and clothing and automobiles and washing machines and every other good that he purchased, and that increase totaled in the year an additional $500 to $1,000, that it would be more difficult for the person who makes $20,000 to pay an additional $1,000 for the goods that he or she needs for their life necessities than it would be for someone making $100,000?

Mr. **Oswald**. That's very clear, Senator, because that person at $10,000 or $20,000 is already spending his money to the maximum means to keep himself and his family alive. That additional $500 or $1,000 in taxes just means that he has to take it away from the food on the table, or it may mean that he can't even stay in the house or apartment that he is living in.

The principle that you have in your bill and that is in the other income tax bills is that we provide a certain personal exemption for basic needs, and then the income tax starts. We believe that is proper and fitting, and that the income tax is graduated, based upon the higher the income—the more they can afford to spend for the country's needs.

Senator Bradley. Thank you.

Mr. Phillips, your tax is a 10-percent flat tax.

Mr. Phillips. Yes, sir.

Senator Bradley. In your statement—I didn't read it—but I thought I heard you say that one of your purposes was the reduction of revenues. Is that right?

Mr. Phillips. Not precisely. What we indicated was that our two primary objectives are to achieve tax equity, in the sense that everyone will be equal before the law and paying the same rate; second, we want to achieve a reduction in taxes in terms of what people have to pay.

We are not fearful of a possible outcome that revenues might be reduced, because frankly we think the Federal Government is spending far too much even if we are operating at the level of a balanced budget.

Senator Bradley. So, from your perspective, if your bill did increase the deficit, your position is, "So be it, there shouldn't be that much spending"?

Mr. Phillips. We are profoundly concerned about the size of the deficit, and it is our hope that, as our bill receives increasingly serious consideration, it will do so in the context of proposals for a budget freeze in concert with proposals for a commodity-based money standard, which would hold down the money the Federal Government has to pay in interest each year. So we are cognizant of the problem of the deficit and we are concerned about it.

Senator Bradley. All right. One last question:

The effective tax rate that is now paid by individuals making more than $100,000—in other words, the tax that they actually pay, the percent of their income that they actually pay—the effective tax rate is 25 percent.

Under your bill, the tax rate is 10 percent. Why would not that be a big tax cut for people making more than $100,000 in income?

Mr. Phillips. Senator, we hope this would be a big tax cut for every American, whatever their level of income. As you know, your bill has three tax rates, effectively—14, 26, and 30 percent—because your bill would repeal indexing, eventually, with inflation, everyone, would be paying a 30-percent rate, and that would constitute a tax hike for a lot of low-income Americans.

So I think if you compare our 10-percent bill with your 30-percent bill, low-income Americans would wind up with a much more equitable position, especially when you take into account the fact that there is a $2,000-per-person exemption under H.R. 5432.

Senator Bradley. Do you allow for the home mortgage interest deduction?

Mr. Phillips. Yes, we do. Where your proposal would cut off the home mortgage deduction at 14 percent, ours would continue it across the board.

Senator Bradley. One of the things that I would like just to reaffirm: All people making more than $100,000 now pay an effective tax rate of 25 percent. Under your proposal and under all flat-tax proposals, but yours is a flat tax at 10 percent, they would be paying 10 percent. So that would mean their effective rate would be reduced from 25 to at most 10 percent. Is that not correct?

Mr. PHILLIPS. Senator, respectfully, I would argue that most of the people who are smart or fortunate enough to earn more than $100,000 a year are also smart enough or fortunate enough to be able to hire tax attorneys that either permit them to evade taxes entirely or to pay them at a rate that is significantly lower than that. I think this would be more equitable, in the sense that it would bring a number of people who should be paying taxes and are earning at a level above $100,000 a year into the tax system.

Senator BRADLEY. The 25-percent effective tax rate is the rate they pay after they have already used all of their tax professional advice and taken advantage of all the preferences. So that's basically the point I wanted to make, Mr. Chairman.

The CHAIRMAN. Thank you very much.

I am not sure—Rudy, you are in pretty conservative company here this morning; I hope it rubs off. [Laughter.]

Because I don't understand how you want to repeal indexing. I have never understood labor's opposition to indexing, since every study shows that it helps workers. Don't you represent workers?

Mr. OSWALD. Senator, we are very concerned with a repeal of indexing in an inflationary period. It is the only automatic tool that Government has, in terms of a macroeconomic tool, other than that of monetary policy.

The advantage of Congress reviewing the need to adjust taxes means that it can use the tax system to cool inflationary periods, and indexing only aggrevates inflationary periods. And in a recessionary period, if Congress does use the tax system to spur the economy, it can do so. And thus, we think that what indexing does is remove the use of the fiscal tool, taxation, for both dealing with inflation and dealing with recessions. And we think that loss of that tool is a major problem that will result from indexation.

No longer will there be a drag on income during inflationary periods, and no longer will Congress have the ability to act in terms of providing for a tax cut to offset a recession.

The CHAIRMAN. Do you support any one of these flat, fair, fast, or the other proposals?

Mr. OSWALD. No, we don't support a flat tax, Senator. We believe that a basic element of a tax system is that those who have more should contribute more, and those who have less should not have taken away from them that little bit they have in order to provide the basic means of supporting the Government.

The CHAIRMAN. Do you have strong opposition to these ideas?

Mr. OSWALD. Yes, Senator. They have been reviewed by our conventions a number of times. We argued against value-added taxes and national sales taxes and flat taxes for the very same reasons. Oral, also, in various State legislatures, we have supported State income taxes on a progressive basis versus a flat tax or a sale tax increase.

There is one thing, if I may just introduce in this sense, and I think Senator Packwood raised it a little bit, and I emphasize it on page 2 of my testimony, and that is, there is much talk today about the cuts in entitlements.

It is very interesting that the basic entitlements—Social Security, unemployment compensation, medicare, civil service retirement, railroad retirement, all have sufficient earmarked funds to take care of their outlays. So in that tax area of entitlements we are raising the money to pay for those programs.

The CHAIRMAN. You indicated the interest in closing loopholes, and I think you supported the 1982 TEFRA and also the 1984 act.

Mr. OSWALD. That's correct, Senator. We believe that closing those loopholes makes a more fair system in that it requires the people who shelter income in those fashions to pay the same general income tax that other people are.

The CHAIRMAN. I am somewhat familiar with your efforts, and we are obviously going to be in contact with probably every witness as we delve into this further after the recess. We have a couple of days hearings, and I assume we will not do much until after the election. And then that would depend on how many people are in each House and who is in the White House on what may happen.

Mr. Phillips, do you cut spending by a freeze? Is that what you were indicating earlier?

Mr. PHILLIPS. We think that's the most likely way to be able to achieve real spending reductions, sir.

The CHAIRMAN. Are there any exceptions to the freeze?

Mr. PHILLIPS. No, sir; although I would hope that Congress would exercise discretion in rearranging priorities within the context of the frozen spending level. In other words, you would say we have "so much" to spend each year, and then within that overall total say "so much" goes for defense, "so much" goes for other areas.

The CHAIRMAN. I have some trouble with people who call themselves conservatives—I am not suggesting you—and then vote for all the spending on the House side, that are still paraded around by your group and others as conservatives. I have never been able to quite figure out how you justify that.

Mr. PHILLIPS. Senator, there aren't many people we call conservatives. [Laughter.]

The CHAIRMAN. You don't think Rudy is a potential candidate?

Mr. PHILLIPS. Everyone's a prospect. [Laughter.]

Senator SYMMS. Mr. Chairman, you know Rudy may not know, but his members out there that I have at town meetings all tell me they want the flat tax at 10 percent. I'm trying to figure out how to get it to pay all the bills. That's my only worry.

Mr. PHILLIPS. Well, we think that some of those bills ought not to be incurred. And it will take time to phase into it; we don't expect it to happen in 1 year or 2 years. But we believe if Congress establishes a goal——

Senator SYMMS. Rudy, the only flat tax they like better than the 10-percent is the 5-percent rate. [Laughter.]

Mr. OSWALD. Mr. Symms, we would be happy with lower taxes, too, but many of our people are paying the higher taxes in two ways—one is the high interest rates on what they are paying on mortgages and home mortgages, and second they are paying for it by the overvalued dollar. It has increased, as you know, by 60 percent in the last 4 years against major currencies, and it's been a major contributing factor to what this year may well be a $90 billion deficit in manufactured goods alone in trade. That's putting an awful lot of people out of work; and we think a major element which the President's own economic report shows in terms of the current deficit is the results of the 1981 Tax Act, nearly three-fifths of the deficit is directly related thereto. The way to address that is to raise the revenue so that we reduce that, reduce interest rates, reduce part of the overvalued dollar, and have jobs in America.

The CHAIRMAN. That sounds like somebody else I've heard recently in Minnesota. [Laughter.]

But in any event, I think we all agree we've got to reduce the deficit, but we don't want to get our priorities mixed up. I think Mondale's priority is raising taxes. For Reagan, that's the last resort. And I think he's on the right track.

But we have tried to act responsibly in this committee. We get accused of a lot of things when it comes to taxes, but we've also reduced spending over a 4-year period by about $92 billion just in initiatives started in this committee. So we get a little irritated sometimes when we see some of our House colleagues who vote for the spending. They vote only for tax cuts; they don't vote for any other thing. And then they claim they are conservatives. I never have quite figured out how that happens, but I guess they've got a good PR agent—or they worked in Treasury for a week or two and left.

Yes?

Mr. OSWALD. But if one increases defense spending dramatically—as has been done and is proposed to be done over the next 4 years—that money has to come from somewhere.

The CHAIRMAN. Right. That used to be the case. [Laughter.]

Well, we appreciate very much your testimony, and we will be working with you in the future.

Mr. OSWALD. Thank you.

The CHAIRMAN. We now have another broad-based panel: Robert McIntyre, Federal Tax Policy, Citizens for Tax Justice; Norman Ture, the Institute for Research on the Economics of Taxation; Fred Wertheimer, Common Cause; and David Keating, National Taxpayers Union.

Mr. McIntyre, I think you can lead off. We will ask that you summarize your summaries, if you can, and your entire statements will be part of the record.

Mr. MCINTYRE. Thank you, Senator.

STATEMENT BY ROBERT S. McINTYRE, DIRECTOR, FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE, WASHINGTON, DC

Mr. MCINTYRE. Thank you, Mr. Chairman. It's a pleasure to be here this morning on behalf of Citizens for Tax Justice, a nationwide coalition of grassroots groups, labor unions, and national organizations. We would like to offer you, in our few minutes, a penny's worth of our thoughts about tax reform.

Earlier this morning, Jack Albertine of the American Business Conference was discussing with Senator Bradley what might be the result if he were to jump off the roof of the Capitol. Well, we don't know for sure whether he would go up or down, either, but it probably would help this committee's actions to simplify the Tax Code if he and a few of his friends were to try it—whichever way they went. [Laughter.]

Mr. McIntyre. I just came back from the Far East, where I visited some countries whose experiences tell a story about the American tax system, in their own ways. One of them is Japan, whose tax system we designed in the early 1950's. And, being unimaginative I guess, the Japanese have pretty much stuck with what we gave them. They still have a system that has very few loopholes, that raises about 30 percent of its revenues from the corporate income tax, that has rather low rates on the citizens, and that is very popular.

The other country is Taiwan, which has imitated us more slavishly. As the American tax system has changed, so has Taiwan's. I'm told by the people there in the Ministry of Finance that their system is now falling of its own weight, that average Taiwanese have lost their respect for it, have started to cheat in great numbers, and think that the system isn't worth living with. Faced with these problems, Taiwan is about to adopt a national sales tax. That is a choice that America may have to face up to next year, and certainly the lobbyists who have given us the current system, with so many loopholes and so many special concessions to particular interest groups, are advocating that we move toward a national sales tax system.

We hope, however, that you will go in the opposite direction, that rather than following Taiwan and following the lead of the people who have given us the mess that we are in today, that you instead will move the tax system back in the other direction toward a tax code that Americans can respect, if not love.

As you know, over the last 6 or 7 years there has been a major shift in the way the tax burden is shared in this country. That shift has been away from those best able to bear the burden and onto lower and middle income workers.

We hope that next year will see a reversal away from that regressive tilt and toward a simpler, fairer system, along the lines of what Senator Bradley has proposed. We think the Bradley-Gephardt plan is an excellent proposal and, with a few changes, should be something that we either adopt outright or at least try to move toward, as Senator Dole has suggested.

The alternatives? They include flat-vote taxes, and value-added taxes, and consumption taxes. Senator Long summed up what was wrong with those approaches 2 years ago when he said about the Hall-Rabushka flat-rate consumption tax, "If you're rich, you'll love it. If you're not, then look out."

The next few years are likely to see major changes in the tax laws. It's an historic opportunity for this committee, it's how your grandchildren and their grandchildren will remember you. We hope you choose wisely.

The Chairman. Norman. It's a pleasure to have you before the committee again.

[Mr. McIntyre's written testimony follows:]

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Statement of Robert S. McIntyre
Director of Federal Tax Policy, Citizens for Tax Justice
Before the Senate Committee on Finance
Concerning Major Tax Reform Options
August 7 & 9, 1984

I appreciate the opportunity to appear before the Committee today on behalf of Citizens for Tax Justice. Our coalition of public interest, labor, and grassroots citizens organizations represents tens of millions of average American taxpayers who have a vital stake in fairer, economically more sensible tax laws.

Summary of Principal Points

1. Our federal tax system is a mess. It is unfair, unnecessarily complex, economically destructive, and failing miserably to raise sufficient funds to run the government.

2. Over the past half decade, there has been a dramatic shift in the way the tax burden is shared in America. Since 1978, inflation-driven "bracket creep" has raised the effective income tax rate on the bottom half of the population by more than 50 percent. Counting higher social security taxes, the federal tax burden on a poverty level family has doubled. The income tax rate paid by the next 30 percent of taxpayers is up by 14 percent or more and social security tax rates on these middle-income families are up by close to 30 percent. At the same time, the effective tax rate paid by the wealthiest individuals—those making more than $200,000 a year—has been slashed by more than a third.

3. Meanwhile, our major corporations are barely contributing at all. According to the most recent study by the staff of the Joint Committee on Taxation, the effective federal income tax rate in 1982 on 213 Fortune-500 companies surveyed was only 16 percent. General Electric, with $6.5 billion in pretax domestic profits in 1981 through 1983, enjoyed tax *refunds* in those years totalling $283 million. Other companies making money off the tax system over the past three years include Ashland Oil, Boeing, CSX Corp., Champion International, Dow Chemical, General Dynamics, W.R. Grace & Co., and on down the alphabet. During the 1950s and 1960s, corporations paid about 25 percent of the federal taxes. In fiscal 1983, the corporate share of the tax burden amounted to a mere 6 percent—and corporate taxes paid for only 4½ percent of federal spending.

4. The primary cause for this huge tax shift has been the explosion in tax loopholes that has occurred over the past decade—most notably on the corporate side. In 1970, there were only $7 billion in corporate "tax exenditures" on the government's official list, amounting to about 20 cents in loopholes for every dollar collected in corporate

taxes. By fiscal 1985, however, Treasury says that corporate tax expenditures will amount to $87 billion. Fiscal 1983 saw $1.67 lost through corporate loopholes for every dollar paid in corporate income taxes and the government now "spends" far more on business tax subsidies than on all programs for the poor combined.

5. Of course, the huge expansion in loopholes has been relentlessly defended by those who benefit from tax concessions as beneficial to the economy. But the actual results have been just the opposite. Not only have the costly giveaways failed to lead to increased savings and investment, not only have they helped send federal deficits and real interest rates soaring, but they also have seriously distorted economic decisionmaking. Tax sheltering, rather than the marketplace, has become the driving force behind many investment choices. Bad investments, entered into only for their tax advantages, have crowded out good ones.

6. The obvious answer to our taxing problems is to close the loopholes and restore fairness, simplicity, and economic common sense to our tax laws. While numerous proposals have been put forward purporting to achieve these goals, in our view only one approach would actually do so—that embodied in the "Fair Tax" program sponsored by Senator Bradley and Representative Gephardt.

7. We are strongly opposed to the "flat-rate-tax" and "consumption-tax" plans that have been suggested by some. As was made clear at this Committee's hearings on the flat-rate tax in September of 1982, abandoning progressive tax rates in favor of a single, flat rate would exacerbate rather than correct the tax shift onto middle- and lower-income Americans that has occurred over the past several years. As Senator Long said two years ago about the Hall-Rabushka flat-rate consumption tax—in a statement that applies with even more force to the "value-added tax" and other national sales tax proposals—"If you're rich, you'll love it. If you're not, then look out."

8. With public discontent with the tax system approaching a critical mass, the next few years may provide an historic opportunity for fundamental improvement in our tax laws. At the same time, however, there is a clear and present danger that the tax system could become even worse. We hope and trust that the members of this Committee and the Congress will choose wisely.

Just Taxes, & other options

By Robert S. McIntyre*

Tax reform. "The more you get into it, the more complicated it becomes," lamented Treasury Secretary Donald T. Regan in the spring of 1983. "But there has to be an easier way."

Indeed, it sometimes seems that almost anything would be preferable to our current Internal Revenue mess. Our federal tax system is unnecessarily complex, widely perceived as unfair, and failing miserably to raise sufficient funds to run the government. And there's certainly no shortage of proposals for fundamental change. Flat taxes, "Fair Taxes," consumption taxes, value-added taxes, even no taxes, all are being pushed from various quarters as the solution to our tax discontents.

So far, the public is hedging its bets. Louis Harris' pollsters found in 1983 that 62 percent of the Americans they talked to supported adoption of a simplified personal income tax with no deductions or credits. But by almost as large margins the same people opposed elimination of specific tax breaks about which they were queried. A majority of the respondents to a 1983 Gallup poll thought a new national sales tax might be the best way to raise taxes, but they also said the main problem with the present system is that it undertaxes the rich and overtaxes the poor.

We're going to have to make up our minds, however, or they'll be made up for us. Despite the fact that hardly anyone in Washington thinks the tax code will be junked all at once in favor of a streamlined system and despite all the maddening philosophical, technical, and political conundrums that Secretary Regan has discovered, significant changes in the tax laws are highly likely over the next few years—if only to bring federal receipts more in line with spending. The need for major action could provide the opportunity to move toward a simpler, fairer, more acceptable tax system. It could also, however, easily lead to a tax system even worse than the current approach.

The American people, it appears, want a change in direction in tax policy. In the pages that follow, the leading tax alternatives will be scrutinized, with a particularly critical look at something called the "progressive consumption tax." To start with, however, it makes sense to review how we got to our present sorry state.

**Director of federal tax policy at Citizens for Tax Justice.*

FROM THE CIVIL WAR TO THE TAX REVOLT

Contrary to President Reagan's oft stated opinion, the progressive income tax was not the brainchild of Karl Marx. Actually, the first federal income tax act was signed into law by Ronald Reagan's premier Republican predecessor, some fourscore and six years after the American colonies declared their independence from Great Britain and 13 years before Marx endorsed the ability-to-pay principle in his *Critique of the Gotha Program*.*

Abraham Lincoln's income tax was a graduated levy, with a $600 personal allowance that exempted most working families and rates as high as 10 percent for incomes exceeding $10,000. The Confederacy copied the Union approach, but with steeper rates. The Civil War income tax was only a temporary measure, however, and in 1871 it was repealed. For the next forty-two years the federal government reverted to its pre-Civil War system of raising revenues—excise taxes and, increasingly, tariffs on imports.

Popular dissatisfaction with the regressive taxes on goods, particularly the import duties, grew stronger and stronger in the latter part of the 19th century. Not only were the tariffs excessively burdensome to those with lower incomes, but they also were part of a protectionist trade policy favoring Eastern manufacturing interests at the expense of working people and farmers.

In 1913, after years of legislative and legal wrangling, Populist and Progressive forces finally succeeded in ending the government's exclusive reliance on flat-rate consumption taxes. The 16th amendment to the constitution was ratified, clarifying federal authority to impose a tax on incomes. That same year, Congress approved and President Wilson signed both the individual income tax and continuation of the corporate profit tax that had been enacted in 1909. Adoption of the federal estate tax followed soon after, in 1916.

Both the defense of and the opposition to the new income tax featured strong rhetoric. Proponents, largely Democrats but also including populist Republicans such as Theodore Roosevelt, called for reinstating Lincoln's levy as a means of taxing the "swollen fortunes" of the rich. Opponents, on the other hand, in attacks orchestrated by major business interests and later to be echoed by Ronald Reagan, decried the income tax as "confiscatory," an "assault on capital," and even "communism." The initial reality hardly deserved such apocalyptic pronouncements. The early individual tax rates, for example, ranged from one to seven percent, with only one American out of a hundred paying any tax at all due to generous personal exemptions. In 1913, the corporate rate was only one percent.

Concern about equity was uppermost in the minds of the income tax supporters. The 1913 House Ways and Means Committee report on the income tax bill summed up the

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*Marx's 1875 *Critique* included the famous maxim: "From each according to his abilities, to each according to his needs." Of course, this was intended more as a principle of social organization than as a suggestion for a graduated income tax. And, actually, Marx didn't invent the line. Instead, he is believed to have been paraphrasing from either Louis Blanc's *Organisation du Travail* (1840) or Morelly's *Le Code de la Nature* (1755). Lincoln probably hadn't read these French authors; he was more likely, however, to have been familiar with the defense of a progressive income tax in Adam Smith's *Wealth of Nations* (1776). *See* page 22 below.

prevailing view:

> "Section 2 of the bill imposes a tax upon the annual net incomes of individuals and corporations. This is in response to the general demand for justice in taxation. . . . The tax upon incomes is levied according to ability to pay, and it would be difficult to devise a fairer tax."

Rates zoomed up to as high as 77 percent on extremely high incomes to fund U.S. involvement in World War I, but those steep rates were quickly reduced after wartime spending needs subsided. At the outset of the Great Depression, total federal taxes amounted to less than five percent of the gross national product, with just over half of that supplied by the corporate and personal income taxes. The individual income tax totalled only 1.4 percent of personal income. Despite a number of changes over the next ten years, federal taxes in 1940 remained at five percent of the GNP, and individual income taxes at 1.3 percent of personal income.

A Class Tax Becomes A Mass Tax

The critical change came with the onset of World War II. Exactions from the rich were insufficient to fund the enormous federal spending the war required, and the income tax was expanded to a broad-based levy affecting almost three-quarters of the population. By 1945, federal tax receipts were close to 19 percent of the GNP, with nine out of every ten dollars in federal revenues coming from personal and corporate income tax collections –which at the time were about equal. The individual income tax amounted to just under 11 percent of total personal income.

Unlike the aftermath of World War I, the German and Japanese surrenders in the mid-forties were not followed by sharp reductions in U.S. taxes. Although the Truman administration at first began cutting back military expenditures to barebones levels, President Truman's desire to reduce the national debt accumulated during the war caused him to oppose congressional efforts to cut taxes. The Republican Congress did force through some tax reduction over Truman's veto, but by 1950 federal taxes remained at 13 percent of the GNP and the individual income tax at nearly 8 percent of personal income. Then, the Korean War pushed up military spending again, and in the ensuing Cold War the decision was made to maintain a large standing army–a peacetime first for the United States. This required money–and, in the fiscal thinking of the 1950s, that meant taxes. By 1955, individual income taxes were back up to almost 10 percent of personal income, and military expenditures were consuming more than a tenth of the GNP.

As national income grew, the military's claim on the GNP gradually declined. But, in the 1960s, Americans became aware of social and economic problems they thought cried out for government intervention. Domestic programs to alleviate poverty and hunger, to assist the elderly, and to reduce discrimination were established or expanded, and eventually became the major focus of federal outlays. In the sixties and seventies, federal taxes averaged just over 19 percent of the GNP and never fell below 18 percent. Individual income taxes generally fluctuated between 10 and 11 percent of personal income. More significant changes, however, occurred in how the tax burden was shared, both among individuals and between personal and corporate taxpayers.

The Business of Loopholes

Efforts to avoid the income tax began early. The 1909 corporate profit tax was defined simply as a tax on "net income," and the 1913 individual income tax law had tracked the language of the 16th amendment to apply to "incomes, from whatever source derived." But loopholes were soon found and "incentives" soon adopted by Congress. Even the initial personal income tax exempted interest on state and local bonds from taxation and provided deductions for mortgage interest, property taxes, and casualty losses. Charitable contributions were made deductible in 1917 as an incentive for philanthropy. By 1918, the oil industry had obtained the two major special write-offs that to this day are the keys to the low taxes of crude oil producers. The tax shelter industry got an early boost in 1921, when capital gains were granted favorable treatment. Upper-income taxpayers quickly learned how to manipulate trusts and partnerships to avoid income and estate taxes.

During the 1930s, the Roosevelt administration called repeatedly for tax reform, particularly for closing the oil loopholes, but made little headway. By the fifties, when Texans Sam Rayburn and Lyndon Johnson controlled the House and Senate, it was next to impossible for a reform-oriented Representative or Senator to gain a seat on the congressional tax-writing committees.

President Kennedy came into office in 1961 with two conflicting goals in the tax area. On the one hand, he wanted to improve tax fairness, but, on the other, he sought to try to use the tax system to stimulate growth with new "incentives." His small victories at the former were more than overshadowed by his dubious successes at the latter. In fact, the roots of our current tax dilemma largely can be traced to Kennedy's tax-based economic policies. Most notably, despite Republican opposition on ideological, free-market grounds and labor antagonism for distributional reasons, the Kennedy administration succeeded in adding to the tax laws a large tax credit for business capital investment. This "investment tax credit" was supposed to be temporary—a "fine-tuning" device to stimulate capital spending during a stagnant period. A decade and a half later, however, it was to become both permanent and the single biggest preference in the tax code.

Late in the 1960s, tax reform forces temporarily regrouped. Spurred by out-going Treasury Secretary Joseph Barr's revelation that there were 154 individuals making more than $200,000 a year paying absolutely nothing in federal income taxes and informed by the path-breaking research of Barr's assistant secretary, Stanley S. Surrey, Congress enacted the 1969 Tax Reform Act. This bill cracked down on a number of notorious tax loopholes and repealed Kennedy's investment tax credit, which had been much criticized for being ineffective and even perverse in its impacts.

Once again, fairness was the dominant theme. The tenor of the times was aptly captured in the Senate Finance Committee's report on the 1969 bill:

> "Increasingly in recent years, taxpayers with substantial incomes have found ways of gaining tax advantages from the provisions that were placed in the code primarily to aid limited segments of the economy. In fact, in many cases these taxpayers have found ways to pile one advantage on top of another. The committee agrees with the House that this is an intolerable situation. It should not have been possible for 154 individuals with ad-

> justed gross incomes of $200,000 or more to pay no Federal income tax. Ours is primarily a self-assessment system. If taxpayers are generally to pay their taxes on a voluntary basis, they must feel that these taxes are fair. Moreover, only by sharing the tax burden on an equitable basis is it possible to keep the tax burden at a level which is tolerable for all taxpayers."

When the 1970s began, even the harshest critics of the tax system generally admitted that the U.S. federal income tax, despite its faults, was still the best, most equitable tax in the world. The American people agreed. For all the good-natured grumbling, as recently as 1972 people told pollsters they considered the federal income tax the "fairest" of all taxes. But beginning with Richard Nixon's Revenue Act of 1971, a new attitude toward the tax system emerged in Washington, an attitude that was to lead to a sharp fall-off in public support for the federal tax laws. Pressed by business lobbies and PACs, Congress gradually lost sight of the original purpose of the income tax. Concerns about fairness gave way to what might be called "loophole mania." Starting with reenactment of an expanded version of the investment tax credit and several other Nixon administration "business incentive" initiatives, Congress began throwing tax breaks at every social and economic problem that emerged.

Abandoning their free-market pretensions, Republicans found the new approach congenial, if not irresistible, since more tax breaks for corporations and the wealthy served their core constituency. Democrats were pleased to have the opportunity to emulate JFK by using the tax code to tinker with the economy. And members of both parties welcomed the campaign support that voting for loopholes invited.

The seventies provided plenty of opportunities for Congress to vote for added tax preferences. As inflation heated up, it drove individual taxpayers, particularly those at the lower end of the income scale, into higher tax brackets, and tax changes were needed simply to keep federal revenues from rising much faster than national income. It seemed easy at the time to divert some of the tax "cuts" necessary simply to offset "bracket creep" into new tax breaks for pet causes and constituencies. But, as the Senate Finance Committee's 1969 report had sagely observed, tax breaks for the privileged few inevitably meant tax increases for the unprivileged many increases that would not be long tolerated. And, by the end of the 1970s, as tax burdens on average citizens grew, the public was becoming increasingly dissatisfied with the federal tax system. The same polls that had found widespread public approval for the income tax in 1972 now found the opposite. Since 1979 the federal income tax has been annually cited as the "least fair tax" by more people than any other tax.

Congress did not quickly get the message, however. In 1980, Ways and Means Republican Richard Schulze of Pennsylvania was not far from the congressional mainstream when he declared:

> "I would like to comment, first, on all this talk about "equity." I hear so much in this room about "equity" and "our search for equity," and quite frankly, I don't think that should be the role of this Committee. Maybe it could be a second-level or a third-level role, but our primary role should be to create incentives through the tax code."

The Reagan Ravagement

With a substantial assist from President Reagan's 1981 tax act, and despite some retrenchment the following year, Representative Schulze's wish has come true. The dominant role of the current income tax is to implement a hodgepodge of government "incentive" policies. In fact, the total amount of revenues the Treasury now forgoes through officially-designated "tax expenditures" is almost as large as the amount actually collected in income taxes. The explosion in loopholes has been most dramatic on the corporate side—up from $7 billion on the government's official list in 1970 to an expected $87 billion by 1985. Fiscal 1983 saw $1.67 lost through corporate loopholes for every dollar paid in corporate income taxes. On the individual side, there now are about 83 cents in "tax expenditures" for every dollar collected in personal income taxes. Even not counting individual relief measures that are not intended to change behavior, one still finds close to 60 cents in individual tax "incentives" for every dollar paid in personal taxes.

What have all these "incentives" done for us?

Well, the most obvious result has been a rather dramatic shift in the way the tax burden is shared. Since 1978, inflation-driven "bracket creep" has raised the effective income tax rate on the bottom half of the population by more than 50 percent. Counting higher social security taxes, the federal tax burden on a poverty level family has doubled. The income tax rate paid by the next 30 percent of taxpayers is up by 14 percent or more and social security tax rates on these middle-income families are up by close to 30 percent. At the same time, mainly due to added loopholes, the effective tax rate paid by the wealthiest individuals—those making more than $200,000 a year—has been slashed by more than a third.

Meanwhile, our major corporations are barely contributing at all. According to a recent congressional study, the effective federal income tax rate in 1982 on 213 Fortune-500 companies surveyed was only 16 percent. Telecommunications firms paid less than 2 percent; railroads chipped in only 4 percent (after paying nothing the previous year); large banks, insurance companies, aerospace firms, and chemical companies got outright tax *refunds*. Among the well-known, highly profitable businesses getting tax money back from the government in 1982 were DuPont, RCA, Texaco, and General Electric. GE's total refunds in 1981 and 1982 of $250 million were garnered despite reported profits in those years totalling $3.5 billion. In the 1950s and 1960s, corporations paid about 25 percent of the federal taxes. In fiscal 1983, the corporate share of the tax burden amounted to a mere 6 percent—and corporate taxes paid for only 4½ percent of federal spending.

As a result of this huge tax shift, average taxpayers are paying more in taxes, but getting no more or even less in government services. To ordinary taxpayers, who see only what they *are* paying, not what others are *not*, it may plausibly look like the government is suddenly wasting a great deal of their money. But the reality is that they are paying the taxes that have been avoided by the politically powerful.

But what of the silver lining? Are the new "incentives" at least helping achieve important economic goals? Apparently not. The huge depreciation tax breaks enacted in 1981, for example, were supposed to increase corporate capital spending. Instead, plant and equipment investment declined in 1983 for the second year in a row—the first time that's happened in the entire postwar era. The new "savings incentives" enacted in 1981 were supposed to be a boost to personal saving. Instead, they have simply attracted funds away from other kinds of saving, and the personal saving rate reached a 33-year record low of 4 percent of disposable income in the second quarter of 1983.

In fact, although the explosion in loopholes over the past decade has been relentlessly defended by Washington lobbyists as beneficial to the economy, the actual results have been just the opposite. Not only have the costly giveaways failed to lead to increased investment, not only have they helped send federal deficits and real interest rates soaring, but they also have seriously distorted economic decisionmaking. Tax sheltering, rather than the marketplace, has become the driving force behind many investment choices. Bad investments, entered into only for their tax advantages, have crowded out good ones.

What tax loopholes—both corporate and individual—have given us in the way of "investment" is lots and lots of paper shuffling. Take, for example, the $485 million tax shelter engineered in the fall of 1982 in which 534 wealthy investors bought Metromedia, Inc.'s entire stock of 45,000 used billboards—with the expectation they'll sell them back in five years after milking the tax write-offs. Or the rampant trading in used office buildings under way in cities across the country, as investors seek "newly-acquired property" to get the enhanced depreciation deductions available since 1981. Or the quadrupling in syndicated tax shelters since 1979, involving, among other things, such highly productive assets as llamas, foreign stamps, and used shopping centers. Or the tidal wave of corporate mergers over the past three years, totalling a staggering $209 billion—with new records predicted for 1984.

Although heralded by backers as the start of a new era in tax policy, President Reagan's 1981 tax victories were simply the continuation of an old one—and they may turn out to have been its zenith. The failure of "trickle-down" policies to boost the economy (and instead the experience of a deep recession followed after much pain by a consumer-led recovery), the news of how the 1981 loopholes virtually wiped out the corporate income tax, the spectacle of profitable companies buying and selling tax breaks, and, most important, the realization by most people that their own taxes have gone up despite the so-called Reagan tax cuts have brought public discontent with the tax system to a critical mass.

One populist-oriented congressional tax staffer may have been speaking for many other taxpayers when he summed up his dissatisfaction with the tax laws this way: "Last year Occidental Petroleum made $720 million and got $25 million back from the government. I made about $50,000 or so and paid something like $10,000 or $15,000 in taxes. Now, the way I figure it, with a little rounding off, I made $720 million less than Occidental—but I paid $25 million *more* in taxes. I'm no dope, but for the life of me I can't figure out how that can be fair."

Belatedly, many members of Congress also are becoming unhappy with their handiwork. Liberal Democrats are discovering that they can't fund social programs without revenues and that middle-class support for the government—and for Democrats—has plummeted as the tax burden has shifted. On the other side of the aisle, principled conservatives look at the wreckage of the free market that tax preferences have given us—and many are aghast.

ESCAPING THE LABYRINTH

So where do we go from here? What kind of tax system do we want? And how do we get there?

The original income tax had low rates and few loopholes. Seventy years later, we have a system that verges on being more loophole than tax. Because so much income is sheltered in one way or another, we've ended up with much higher tax rates on what's left—primarily wages. And even with those high statutory rates, the tax system falls far short of raising sufficient revenues to fund the government. Moreover, there is widespread agreement that the loopholes and special breaks are causing serious harm to the economy.

The obvious answer is to close the loopholes and restore fairness, simplicity, and economic common sense to our tax laws. Indeed, there are numerous politicians talking about doing exactly that. But, while all the suggestions call for a simpler tax system, they differ radically in their definitions of equity and economic efficiency.

At a fundamental level, the current tax debate raises the same kinds of issues that were threshed out prior to adoption of the original income tax way back in 1913. Now, as then, there are those who want to establish a simple income tax system with relatively low, but progressive tax rates. Raising their voices against this approach now, as then, are those who condemn the concept of rate graduation. Also now, as then, there are those who contend that consumption rather than income should be the target of taxation. And, now, as then, quite a lot rides on which direction we choose to take.

The Fair Tax

The leading current proposal for a simplified, progressive income tax comes from two Democratic members of the congressional tax-writing committees, Senator Bill Bradley of New Jersey and Representative Richard Gephardt of Missouri. Their "Fair Tax" would reverse the direction tax policy has taken for the past decade or so, by wiping out most special tax breaks on both the personal and corporate sides of the tax ledger. It would also increase standard deductions and personal exemptions so that taxes no longer apply to poverty-level incomes, and would cut statutory tax rates. For about 80 percent of American individual taxpayers, the tax rate would be 14 percent of income in excess of the standard deduction and exemptions (which would total $11,200 for a family of four). The top tax rate—applicable to corporations and to families earning more than $65,000—would be 30 percent.

The Fair Tax would retain a handful of popular tax deductions—for mortgage interest, property taxes, state and local income taxes, and a few others—but they would be limited to saving taxpayers 14 cents for each dollar deducted (unlike the current system, where the more you make, the more the deductions are worth). And, because of the significantly larger standard deductions, far fewer taxpayers would utilize the option to itemize.

The Bradley-Gephardt plan offers a radically simplified tax system that basically gets the government out of the business of trying to influence investment decisions through tax "incentives." Gone would be tax breaks for speculating in gold or collectibles, tax shelters in used shopping centers and billboards, and tax subsidies for companies to move their factories overseas. No longer would loopholes rather than real profit opportunities dominate so many private sector choices. Thus, the Fair Tax is responsive both to complaints about the tax code's complexity and to criticisms that most of the current "incentives" have proven either ineffective or counterproductive in achieving their putative economic goals.

What about winners and losers? Well, because rate reductions are combined with a general crackdown on loopholes, most taxpayers will not be indifferent to the Fair Tax in terms of their actual tax bills. For example, under the Fair Tax, a couple with two children earning $15,200 would pay taxes on $4,000 at a 14 percent rate. The family's tax bill would be $560–about a $250 cut from present law. A typical family of four making $30,200 would pay taxes on $19,000, and have a tax bill of $2,660–about $200 less than currently (even though the family no longer itemizes deductions).

For upper-income individuals, the top tax rate under the Fair Tax would drop to 30 percent from the current 50 percent. But the well-off would no longer be able to shelter much of their income through loopholes. Bradley and Gephardt present an example of a family making $120,000 that would get a 9 percent tax reduction under the Fair Tax, and offer another example of a family with the same income that would owe 46 percent more in taxes. (Each, by the way, would have the same tax bill under the Fair Tax–amounting to about 20 percent of earnings.)

Overall, Bradley and Gephardt estimate that about 30 percent of individual taxpayers–those making exceptional use of tax breaks under present law–would pay higher taxes under the Fair Tax. The remaining 70 percent of us would pay somewhat less.

Similarly, on the corporate side, despite the drop in the corporate rate from 46 percent to 30 percent, many companies would pay significantly more in taxes than they do now. This isn't suprising, of course. As noted earlier, the average 1982 tax bill for 213 Fortune-500 companies studied by the staff of the congressional Joint Committee on Taxation was only 16 percent–and about a quarter of the industries paid less than 10 percent. On the other hand, some companies that now pay high taxes would get tax cuts under the Fair Tax. It has been suggested, for example, that many high-tech firms would benefit from the Bradley-Gephardt approach.

Although Bradley and Gephardt can rightfully claim that their program would enhance both tax equity and economic efficiency, they admit they do not solve two critical and related additional problems in current law. The first is the federal government's urgent need for added revenues to narrow the deficit. The second is what many believe to be the equally important imperative to reverse the radical shift in tax burdens that has taken place over the past several years. Although the Fair Tax does rearrange tax burdens within income classes, the authors say that it roughly reproduces both the current level of revenues and the current average distribution of taxes at different income levels (with the notable exception that the poor no longer would be taxed).

Bradley and Gephardt may well be too modest about the impact of their program on revenues and tax progressivity. In the longer run, their restructuring of business taxes seems almost certain to lead to an increase in corporate tax payments and to a larger decrease in upper-income tax shelters than their estimating model is capable of measuring. And at least some improvement in compliance with the tax laws also would be likely. Studies have shown that cheating declines when taxpayers believe in the equity of the tax laws, and the Fair Tax's basic principle—as Senator Bradley puts it, that "if you manage to do well in this society and to benefit economically, then you should pay a somewhat higher tax rate than those individuals who find themselves struggling from paycheck to paycheck"—fits in well with popular notions of what tax fairness is all about.

Moreover, it's possible to move toward a Fair Tax in stages, through the kind of loophole-closing programs that Senator Bob Dole, Republican Chairman of the Senate Finance Committee, among others, has been promoting. So the Fair Tax is an action agenda, not an excuse to do nothing until the millenium arrives and all loopholes are closed at once. And, by making some rather modest changes in tax rates and by attacking some of the tax preferences, particularly on the business side, which the Bradley-Gephardt plan leaves intact, the program's problems of insufficient progressivity and revenue shortfall could plausibly be resolved (as is illustrated by an adaptation of the Bradley-Gephardt plan proposed by the International Association of Machinists and Aerospace Workers as part of their "Rebuilding America" program).

Flat Raters

Competing with Bradley-Gephardt-style income tax reforms for popular support are a variety of proposals for "flat-rate taxes." As the label suggests, these programs would abandon graduated tax rates in favor of a single rate. In addition, most of them would replace the income tax with a tax solely on personal consumption.

One version of the flat-rate approach is the "value-added tax," or "VAT," a complicated national version of the familiar retail sales tax collected in almost every state. Like a regular sales tax, the VAT would be paid in full by retail consumers when they purchase goods. In addition, the tax would be collected, and then rebated, at various stages of production—a device widely used in Europe to combat tax evasion at the retail level. Unlike a sales tax, however, the VAT would be included in the price of goods rather than added on at the time of purchase, so that its impact would be largely hidden—a feature that some see as politically advantageous.

Closely related to the VAT are most of the so-called "flat-rate income tax" proposals that have received so much recent attention. Through one means or another, a majority of these "income tax" plans would exempt money saved or invested—and therefore tax only spending, as under a sales tax. These flat-rate proposals differ functionally from a VAT primarily in that they would provide an exemption for the very poor.

Supporters of the various flat-rate proposals, including VAT, tout their systems as being loophole-free. Such claims are highly misleading. Yes, these programs would curb tax breaks for homeowners and end the exemption for social security benefits. But they also would retain and expand the most significant tax "incentives" enjoyed by people wealthy enough to save and invest large sums. In fact, by exempting all saved income—including all undistributed corporate profits—these plans simply would consolidate the current array of "savings and investment incentives" into a single sweeping loophole.

In effect, the flat-rate plans, directly or indirectly, would generalize the system of excise taxes and customs duties that prevailed as the federal government's main revenue source prior to adoption of the 16th amendment. As might be expected, such a radical step would have a major impact on the distribution of tax burdens.

In an attempt to hide that impact, many of the flat raters engage in some rather outrageous political demagoguery. For example, Senator Jesse Helms of North Carolina, Representative Phil Crane of Illinois, and, before he became President, Ronald Reagan all have said they favor replacing the current tax system with a flat *10-percent* consumption tax. (As a concession to the truly needy, families with incomes substantially below the poverty level would be exempt.) These gentlemen have traced their choice of a 10-percent tax rate to the old Christian practice of tithing, and Crane says the approach would cut taxes for virtually all Americans. He's not quite right—many lower-income people would pay considerably more due to reduced exemption levels. But the 10-percent tax these men have proposed would indeed be a considerable tax cut overall—in fact, it would add as much as $175 billion a year to the federal deficit.

More carefully thought out from a revenue point of view, although still very sketchy in other respects, is the flat-rate consumption tax introduced in Congress by Senator Dennis DeConcini of Arizona. Authored by Robert Hall (a participant in this volume's colloquium) and Alvin Rabushka of Stanford's Hoover Institution, this plan would tax all unsaved income at a 19 percent rate (with exemption levels roughly similar to those in current law).

Hall and Rabushka admit that their program—and any serious flat-rate plan—would dramatically slash taxes on the rich and the corporate sector and raise taxes on almost everyone else. That is, a flat tax would accentuate the tax shift onto middle- and lower-income taxpayers that has been going on for the past decade. The theory, which Hall and Rabushka state bluntly in their book, *Low Tax, Simple Tax, Flat Tax* (1983), is a depressingly familiar one:

> "Now for some bad news. [Our] simple tax does not make everybody better off straight away. . . . Until a response to improved incentives takes place, it is an obvious mathematical law that lower taxes on successful people will have to be made up by higher taxes on average people. . . . If incomes remain exactly the same after tax reform, then the poor and the middle class subsidize the rich. . . . But quickly everyone will benefit from the increased economic activity that will accompany a dramatic improvement in the incentives facing the most critical participants in our economy."

Now, note that Hall and Rabushka are not talking here about the economic benefits which almost surely could be gained from closing loopholes that foster tax shelters and divert capital and effort into less productive areas. Nor are they touting the supposed economic improvements that switching to a consumption tax might produce (discussed below). Elsewhere in their book, they do make arguments for these intended elements of their program, but on behalf of abandoning graduated tax rates their economic case is nothing but a restatement of Andrew Mellon's famous "trickle-down" dictum that "the prosperity of the lower and middle classes depends upon the good fortune and light taxes of the rich."

Why do the flat raters subscribe to this theory? Aside from repeated references to the rich as "the most critical participants in our economy," as "the most productive and highly paid . . . part of our population," and as "bright people," Hall and Rabushka don't tell us. They certainly offer no explanation for the disappointing results from our most recent experiment with "trickle-down" policies the 1981 Reagan tax act. And, while they point to Hong Kong and the Isle of Guernsey as evidence that a flat rate works, they ignore a much larger body of experience that shows economic growth and inequity are inversely correlated.

In its 1982 annual report, for example, the congressional Joint Economic Committee investigated whether there was any connection between inequality and prosperity in the economies of America's major trading partners. It found the truth to be "just the opposite. These countries with above average inequality have grown less rapidly than the more nearly equal countries." Writing in the March 1982 issue of *The Atlantic*, conservative American Enterprise Institute scholar Michael Novak reached a similar conclusion. It's no coincidence, he found, that the United States historically has combined exceptional economic growth with continued improvements in economic fairness. Looking back over 400 years of economic history, in fact, countries with "relative equality" of income, wealth, and political power have had by far the most economic success. On the other hand, "a narrow concentration of wealth has negative effects" that are "quite visible" in countries and regions whose economies have not performed well.

Likewise, a number of analyses of Japan's economic success have pointed to that country's relatively equal distribution of incomes as a major factor in encouraging both worker-management cooperation and entrepreneurship. According to *Time*, for example, the highest paid individual in Japan was recently disclosed to be a baseball player making $740,000. In contrast, the highest paid American corporate executive in 1982, Frederick W. Smith, Chairman of Federal Express, pulled down more than $51 million (and the second and third place finishers in the executive pay derby earned $44 million and $15 million, respectively). In its special issue on Japan, *Time* also cited several examples of successful, relatively highly paid Japanese who, while complaining about high taxes, said they had redoubled their efforts in response.

Whatever their views on "trickle-down" theory, most members of Congress are usually and understandably reluctant to support large tax increases on most of their constituents, at least if the increases are so visible that the voters will almost certainly notice them and know whom to blame. Thus, after the outrageously regressive and impolitic distributional consequences of the various "flat-rate income tax" schemes were pointed out by numerous witnesses at Senate Finance Committee hearings in 1982, most members of the Committee were quick to disavow any interest in the idea.

Leading the retreat was former (and perhaps future) Finance Committee Chairman

Russell Long, who took to the op-ed page of *The Washington Post* to denounce the Hall-Rabushka flat tax. "If you're rich, you'll love it," said the Louisiana Democrat. "If you're not, then look out." Long's spirited defense of graduated tax rates was ironic, in light of the fact that only two years earlier he had joined then House Ways and Means Committee Chairman Al Ullman (D–Ore.) in proposing a federal value-added tax as a partial substitute for the income tax. Since the main difference between Long's VAT and the Hall-Rabushka plan is that the two Stanford professors at least find it seemly to exempt the very poor from tax, Long seems to be reading the political tea leaves differently than he did in 1980. His thinking may have been influenced by the fact that Ullman was retired in 1980 by the voters of Oregon, one of the few states still without a retail sales tax. The fact that a VAT is a hidden tax, while the Hall-Rabushka flat tax is not, may also have colored Long's opinion.

The Progressive Consumption Tax

Although abandoning graduated tax rates seems to be at least temporarily out of vogue, the idea of switching from an income tax to a tax solely on spending may be gaining ground. Over the past decade, a great deal of academic effort has been expended to try to demonstrate that such a switch need not be based on "trickle-down" principles. Instead, it is argued, it's possible to have a consumption tax that is progressive.

A *progressive* consumption tax? How do you do that? Well, actually, the theoretical mechanism is pretty clever. In order to retain graduated tax rates, advocates of a progressive consumption tax eschew direct taxes on spending, such as a sales tax or value-added tax. Instead, they would retain the trappings of the income tax, but allow a tax deduction for money saved or invested (an approach similar to that followed by some of the flat-rate plans discussed earlier). Moreover, and this is critical, "negative savings"—money either borrowed or taken out of savings—would be added to income in computing taxable consumption. Since, by definition (and ignoring gifts), people must either save or spend their earnings, a tax deduction for savings and an add-back for "negative savings" is a slick way to measure an individual's actual consumption expenditures in a given year.

The idea of a "progressive consumption tax" has caught the fancy of a wide range of pundits whose views normally span the political spectrum. Liberal economics writers Lester Thurow and Robert Reich endorse the approach. So do the Reagan administration's conservative chief economist Martin Feldstein and the Treasury Department's assistant secretary for tax policy John Chapoton (although these two officials intimate that they might prefer a flat-rate consumption tax were its distributional consequences not so impolitic). It sometimes seems that every economist under 40 has jumped on the progressive consumption tax bandwagon, too.

Progressive consumption taxers believe their system's technical cleverness allows them to achieve a number of seemingly inconsistent tax goals simultaneously. The supposed need for "investment incentives" that provided the rationale for the loophole-poking tax approach of the past decade would be met by carving out one giant loophole for all funds saved or invested. Fairness allegedly would be retained, or even enhanced, by properly setting the tax rates and, perhaps, by beefing up inheritance taxes. The political process that produced the current hodgepodge of tax breaks and all the investment distortions they entail would be short-circuited by putting all savings and investment on an equal footing—that is, tax-exempt. Knotty problems involving inflation and several other capital-income issues would be defined away. In fact, many proponents of the progressive consumption tax believe that the only real difficulty with their proposal involves overcoming public misconceptions about it.

That perceived political problem is certainly real. In fact, up till now, most elected officials have been wary of giving any kind of consumption tax—progressive or flat-rate—a straightforward endorsement, figuring that the voters would react negatively to the idea. Al Ullman's unhappy experience with the citizens of Oregon after he proposed a VAT in 1980 offers one illustration that this political assessment probably is correct. Another example was provided in the spring of 1983, when President Reagan suggested he might favor outright repeal of the corporate income tax—one of the key elements of the consumption tax package its supporters often fail to mention. "I'll probably kick myself in the morning for saying this," Mr. Reagan predicted, and he was right. The President's off-the-cuff remark was greeted with an uproar of popular indignation and was quickly followed by official denials that the administration was planning to pursue the President's idea.

Senator Gary Hart has bravely promoted the progressive consumption tax for several years as one of his "new ideas." But this Democratic presidential candidate is now hedging his bets by supporting a reformed progressive income tax as well. Hart has found that merely the term "consumption tax" is politically frightening. "If anyone can think of a better title for this than 'expenditure tax' or 'consumption tax,' " he complained in 1982, "I would certainly welcome it." To try to deal with the problem Hart identifies, assistant Treasury secretary Chapoton calls his favored plan a "tax on consumed income." His predecessor under President Ford preferred the name "cash-flow tax," while corporate lobbyist Charls E. Walker is trying out "tax on business transactions" as a euphemism for his (flat-rate) value-added tax propcsal.

From the other side of the Sierra Nevadas, Robert Hall and Alvin Rabushka came up with the most innovative, and for a time successful, approach to the nomenclature problem on behalf of their so-called "flat-rate income tax." The following exchange between Senator Bill Bradley and Robert Hall at a 1982 Senate Finance Committee hearing (which echoes much of the discussion in this volume's colloquium) illustrates that novel approach, and shows how it eventually ran afoul of Abraham Lincoln's famous aphorism about fooling people:

> Senator BRADLEY. I would like to get a little better understanding of what your plan really is. . . . When you say you tax *income* only once, what does that mean? . . . [W]hat I am getting at is that we had a couple of witnesses earlier in these hearings say that what they were for was a tax where if you spent the money, you paid a tax on that. But if you didn't spend it, if you saved it or reinvested it or whatever you wouldn't pay a tax on that. Now we call that a consumption tax.
>
> Mr. HALL. Right.

> Senator BRADLEY. What is the difference between that tax and the one you have advocated?
>
> Mr. HALL. None at all.
>
> Senator BRADLEY. None. So you are advocating a consumption tax?
>
> Mr. HALL. That's right, but we are careful not to label it as a consumption tax.

In a country in which people will pay good money for pet rocks, however, packaging difficulties may not be insurmountable. Moreover, even impractical ideas can influence policymaking. So, whether or not the progressive consumption tax advocates have any realistic prospects of getting over their marketing hurdle, the substantive merits of their idea still need to be scrutinized.

Answering the wrong economic question badly

In his popular 1983 book, *The Next American Frontier*, Robert Reich repeats the most commonly stated argument for abandoning the income tax in favor of a graduated tax on spending. "The progressive consumption tax," he asserts flatly, "would encourage more savings." Reich does not belabor the issue of whether more saving would be desirable—in fact, he never discusses it. Nor do most economists who agree with Reich's conclusion. Instead, they are content to construct mathematical models that purport to show an inherent bias in the income tax *against* saving and investment. This is a serious distortion, they contend, whereas exempting money saved or invested from tax would be "neutral."

Neutral compared to what? you may ask. Compared to no taxes at all, retort the consumption taxers. On its face at least, this comparison seems unusual. Would the economists who push the consumption tax favor steep taxes on apples and no taxes on oranges because that would leave the incentive to buy oranges the same as if there were no taxes at all? Of course not. They would quickly recognize that such a system would create a bias in favor of oranges and against apples, hardly a "neutral" result. But, unless we are to abandon all taxes and fund the government entirely on debt (as one former top-level Reagan administration Treasury official has suggested), a tax system that exempts capital must necessarily impose steeper taxes on something else—say, wages. And this, one might argue, could hurt the economy by discouraging work in favor of goofing off.

The old-fashioned view was that the tax laws ought to be more concerned about deterring toil than about stifling the incentive for thrift. Savers, it was thought, are primarily motivated by their desire for economic security and, sometimes, power, with the after-tax interest they earn a far less important factor. Indeed, it used to be pointed out, some people put their savings in a sock or under a mattress. For workers, on the other hand, after-tax wages were considered to be the key force driving them to forgo leisure, expend effort, and put up with the other inconveniences of holding a job, such as getting up in the morning. Thus, quite the opposite from the thinking of the modern consumption taxers, it once was a popular notion that capital income should be taxed *more* heavily than wages. The original 1913 income tax law, for example, set generous personal exemptions that intentionally exempted almost all wage-earners from taxation, and the tax fell primarily on capital income—the "swollen fortunes of the rich." In 1969, Congress concluded that wage-earners have to make more sacrifices than savers to turn a penny and set the maximum tax rate on wages at 50 percent, compared to 70 percent on "unearned" investment income. (This rule remained on the books until it was repealed in 1981.)

As economic analysis goes, however, all the above is pretty simple-minded. Mere theorizing, it has been shown, produces "indeterminate" answers about the incentive effects of a consumption tax versus an income tax. A serious economic evaluation ought to examine the various incentives and disincentives to work or not to work, to save or not to save, and then try to measure the impact of various tax rules on those incentives based on real evidence. Thus, for example, the conclusion that people will save more if the after-tax rate of return is higher—the underlying theme of the consumption taxers' case—may be true some of the time. But it is equally clear that many people will save more if the rate of return is *lower*. If I'm saving to put my little girl through college and interest rates go down, you can be sure that I'll increase my savings rate if I can, to assure that my daughter's education will be paid for. Likewise, if you're trying to save enough to fund your retirement, a lower interest rate may persuade you to set aside more.

Similarly, higher wages may cause some people to work longer hours. But the history of this century is that higher wages have gone together with *shorter* work weeks. People found they could live reasonably comfortable lives with less effort—and they did so.

Most empirical evidence simply fails to support—in fact, undermines—the consumption taxers' case about the impact of taxes on saving. Enactment of a variety of tax breaks for capital income over the years has had no clear impact on the saving or investment rate. Tens of billions of dollars in new corporate investment "incentives" were adopted in the 1970s, but the overall national investment rate stayed at the same 16 percent of the GNP it had averaged since the end of World War II. Tax breaks for Individual Retirement Accounts were greatly expanded in 1981, and in the second quarter of 1983, when the new "incentives" were fully effective, money did indeed flood into IRAs. But all of that and more flowed out of other savings, so that the personal saving rate hit a 33-year low (as did the overall national saving rate). A 1983 Congressional Research Service study of various countries found that the ones with the highest taxes on capital also enjoyed the highest rates of saving and investment—the most notable example being Japan.

Faced with this kind of real-world data, the best and most honest of the consumption tax advocates, such as William Andrews of Harvard and Rudolph Penner, director of the Congressional Budget Office, carefully avoid making grandiose economic claims for their position. Penner, for example, has cautioned: "I don't think the consumption tax would have large effects on either saving or work effort."

* *

But, even if we could, would we want to install a tax system that would lead to a higher level of savings and investment? Do we need to divert a larger share of our resources away from buying the goods and services we'll otherwise be capable of producing and into expanding our capacity to create still more? Despite the forceful assertions of self-interested lobbies, a yes answer to these question is not self evident—nor is it supported by the actual evidence.

Looking at the big picture, the Federal Reserve Board, in a 1981 study titled *Public Policy and Capital Formation*, concluded that America's overall level of saving and investment was probably "optimal" from the point of view of a healthy, productive economy (and that our main capital problem was misallocation, due largely to tax loopholes). Likewise, a 1983 report by the Presidential Commission on Productivity determined that insufficient investment was not the cause of the decline in American productivity growth. Focusing more narrowly, on the automobile industry, production experts Kim Clark, Alan Kantrow, and the late William J. Abernathy, in their 1983 book, *Industrial Renaissance*, found that our problem with Japanese competition had no apparent connection with levels of capital spending–in fact, that our capital investment per worker in autos is double that of Japanese companies. When California business consultants and part-time Stanford professors Thomas Peters and Robert Waterman, Jr. of McKinsey & Co. looked for lessons from "excellent companies" in their best-selling 1983 treatise, *In Search of Excellence*, capital investment levels were discounted and tax breaks never mentioned. In short, the oft-repeated contention that inadequate capital spending is the root of our economic problems is rapidly being discredited.

On the other hand, an oversupply of capital, coupled with insufficient demand, is not a danger to be lightly dismissed. Historically, it has been the chronic dilemma of market-based economies and is precisely the problem the federal government's economic policies have concentrated on trying to avert since the Great Depression. Although "demand management" fell out of favor in the seventies, it has made a remarkable comeback recently. The policies of President Reagan and his Federal Reserve Board Chairman Paul Volcker have shown that deep recession and extremely high unemployment will indeed curb inflation and that huge budget deficits will indeed spark a consumer-led recovery.

Of course, there can be situations in which government policy is too pro-spending and too anti-investment. The long-run–as opposed to the current–federal deficits appear to create a real danger that long-term investment will be insufficient unless the government gets its fiscal house in order. But this is a problem of macroeconomic policy–not a problem of incentives.

In recent years, it has become politically fashionable to promote tax changes as magic solutions to all our economic woes. Speaking unkindly of his former supply-side compatriots, for example, Budget Director David Stockman told reporter William Greider in 1981 that "[w]henever there are great strains or changes in the economic system, it tends to generate crackpot theories which then find their way into the legislative channels." Stockman hasn't intimated where he stands with regard to the consumption tax. But, among experts with no axe to grind, there is very limited support for the idea that switching to a consumption tax would be an economic panacea–or that it would even be economically beneficial at all. At a 1979 Brookings conference, titled *What Should Be Taxed: Income or Expenditure?*, the consensus of the assembled top tax analysts was that the supposed economic advantages of a consumption tax are either non-existent or unproven.

Averaging fairness out of the system

However little or much they credit the economic claims for taxing only spending, most advocates of the progressive consumption tax believe that, by assuming complete freedom to set tax rates, they have defined away the issue of tax fairness. If you are the average middle-income taxpayer, they say, we can keep your tax bill exactly where it is now. Moreover, they continue, we can do the same for the average poor family and the average rich person. Or we can change the average distribution to take more or less in taxes from any group depending on society's preferences about redistribution. And, therefore, they conclude, a progressive consumption tax could be just as fair—if not more so—than the current income tax.

Mathematically, the claim that a consumption tax can be as progressive on average as an income tax seems irrefutable. If we decide, for example, that people earning $30,000 a year should pay 10 percent of their income in taxes, and the average person with that income saves $3,000 a year, then a tax rate of 11.1 percent on those people's spending will give the same average result as a 10 percent income tax. But what about people making, say, $50 million a year? Under the Bradley-Gephardt income tax, such people would pay about $15 million in taxes. (That's a hefty sum—but they can afford it. After all, they'll still have $35 million left after-tax.) How could a consumption tax approximate this result? Someone earning $50 million probably has time to spend only a million or two of it. For a consumption tax to assess a $15 million tax on $2 million in spending, the rate would have to be 750 percent. This works arithmetically, but it's hardly a likely political outcome.

Even if we accept the cock-eyed assumption that there is no built-in bias in the consumption tax toward a less progressive tax system, however, the progressive consumption tax supporters who believe they have defined away the fairness issue are correct only if tax fairness involves nothing but the *average* distribution of tax burdens.

To be sure, average distribution is a key fairness concern, probably the most critical. By asserting that they can achieve any average distribution of tax burdens that is desirable, the consumption taxers may have narrowed the fairness debate between taxing spending and taxing income. But is average distribution all there is to fairness?

Consider who it is that supporters of the progressive consumption tax feel should be paying more in taxes. People who save a lot would do well under a spending tax, of course, but people who save less than average would fare poorly. Particularly hard hit would be those who spend *more than their incomes*. Who might we expect to find in this last group? Some examples that come to mind include students borrowing to fund their educational expenses; elderly people drawing down their savings to pay their living costs; unemployed individuals forced to deplete their bank accounts or borrow in order to put food on the table; and families taking out loans for major purchases, such as a car or a home.

Perhaps some of these hardship cases could be dealt with by special rules. Consumption tax advocates have suggested, for example, that auto loans and mortgages could be treated differently from other kinds of borrowing. And adequate exemption levels could mitigate problems for the truly down-and-out. But is a tax system that starts with the premise that the best time to tax people is when they most need to borrow or to spend their savings appealing on fairness grounds? Certainly, the mere assertion that, on average, things will work out is not a sufficient answer.

* *

Despite the apparent problems, some consumption tax supporters do try to make a fairness case for taxing income only when it is spent. Typically they begin by quoting or paraphrasing Thomas Hobbes. Three hundred years ago, in *Leviathan*, Hobbes wrote:

> "To equal justice, appertaineth also the equal imposition of taxes . . . [T]he equality of imposition, consisteth rather in the equality of that which is consumed, than of the riches of the persons that consume the

> same. For what reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged, than he that living idly, getteth little, and spendeth all he gets; seeing the one hath no more protection from the commonwealth, than the other? But when the impositions, are laid upon those things which men consume, every man payeth equally for what he useth . . . ."

What Hobbes seems to be suggesting in the passage is that taxes ought to be a charge for the benefits a person gets from society, and that consumption is a better measure of those social benefits than is wealth. (Hobbes didn't discuss the possibility of an income tax, a concept that probably never occurred to him. The tax debate in England at the time was solely between property taxes, on the one hand, and tariffs and excises, on the other.)

The idea that taxes ought to be based on benefits received from government is not without intuitive appeal. In fact, we apply such a benefit principle in a number of areas: gasoline and tire taxes are used to build and maintain highways; water and sewers are largely financed through "user fees"; social security benefits are very roughly related to payroll taxes paid in the past. But as a general principle of taxation, the benefit approach quickly breaks down. It suggests, for example, that welfare receipients should pay a tax equal to their welfare check plus their pro-rated share of common benefits such as national defense, space exploration, aid to the arts, and so forth. Moreover, what clear relationship is there between someone's spending and his or her share of the services provided by the government? Does a person who spends $100,000 enjoy a greater benefit from, say, the Defense Department than someone who spends $50,000? What if the latter person has greater wealth to be protected, or a larger family?

The benefit theory of tax fairness is a dead end on its own. But it can be reformulated as an appealing slogan: "People should be taxed on what they take out of society [that is, consumption] rather than on what they put in [that is, savings]." With this slogan in mind, consumption tax advocates turn to the ideas of John Stuart Mill.

One hundred years ago, Mill put forth the proposition that the income tax was unfair to savers because people are "taxed twice on what they save, and only once on what they spend." If a saver earns interest, Mill argued, "it is because he abstains from using the principal; if he spends the principal, he does not receive the interest. Yet because he can do either of the two, he is taxed as if he could do both . . . ."

Why spending is the only use of money that should be relevant to taxation was a question Mill left unanswered. But his modern followers have tried to bring meaning to his "double taxation" rhetoric by making the following argument. Interest, they say, is a fee paid by lenders to borrowers to encourage the latter to defer immediate consumption. In order to equalize the situation of people who spend now and those who spend later, the value of the savers' deferred consumption should be equal to the value of the spenders' satisfaction from consuming immediately. Or, put another way, savers should be allowed a deduction for their "cost" of deferring their spending—that "cost," by definition, being exactly equal to the interest they were paid. In other words, interest should be tax-exempt—a result whose mathematical equivalent in this simple example can be achieved by allowing a tax deduction for savings and taxing income only when it is spent.*

Possessed of two attractive slogans—"Tax People On What They Take Out Of Society—Not On What They Put In" and "End The Double Taxation Of Savings"—most consumption taxers who have gotten this far rest their fairness case.

But if these slogans prove anything, they prove far too much. If savers are allowed to deduct their psychological "costs" of deferring gratification, why shouldn't workers be allowed to deduct their "costs" in effort and foregone leisure in computing their wage income? If savers are "putting resources into society rather than taking resources out," does not the same apply to workers whose efforts create the goods and services society desires? Is not a consumption tax a "double tax" on wages, taxing workers on their consumption but giving them no credit for the resources their work has created?

The "double tax"slogan is a trap, as some consumption tax advocates admit. Assistant Treasury secretary John Chapoton, for example, concedes that the income tax "is *not* a double tax on savings as some have asserted; it is a single tax on capital income." Moreover, Chapoton acknowledges, a "uniform income tax would be consistent with most people's conception of equity," while a consumption tax could raise a significant "concern" about excessive wealth accumulation. Chapoton offers no fairness argument for favoring savers, but instead opposes even a "single tax" on capital income based on the kind of dubious economic reasoning discussed earlier.

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Chapoton's discreet refusal to pursue the "double tax" argument may have been the better part of valor, for those consumption tax proponents who do trudge ahead end up revealing a profound distaste for ordinary notions of tax fairness.

It's a truism among tax analysts that the tax laws should avoid unnecessary interferences in the operations of the marketplace. In the early seventies, tax theorists began exploring how far we would need to go to achieve a tax system with absolutely *no* effects on economic behavior. Their answer, put forward almost satirically, was modestly labelled the "optimal tax." Simply put, the "optimal tax" would be a lump-sum tax imposed on everyone without regard to income, consumption, or any other personal characteristic whatsoever. Since no particular activity would be taxed, worries about deductions for psychological costs and "double taxation" could be dispensed with. In its "ideal" form, the optimal tax would be imposed on a one-shot basis without debate by Congress, thereby eliminating opportunities for taxpayers to evade the tax by leaving the country. Currently, a one-time, lump-sum tax of roughly $40,000 per capita—or $160,000 for a family of four—would be about right to provide the federal government with a perpetual endowment so that no further taxes would be required. The economic beauty of the lump-sum optimal tax, we are told, is that no matter what people do, they still have to pay it. Workers pay, savers pay, goof-offs pay, spendthrifts pay. Unfortunately, its designers admit, unless one assumes that everyone starts off with the same wealth, ability, and opportunities, the optimal tax is an absurdity from a fairness point of view.

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*The numbers run as follows: If someone who's in, say, the 30% tax bracket earns $100, he will keep $70 after-tax. If he puts that $70 in a savings account paying 10% interest, after a year he will have $77 available to spend if interest is tax-exempt. Alternatively, if he's allowed a deduction for the amount he saves, he can put $100 in the bank at the outset. After a year, that will grow to $110. If he then takes the money out of the bank, he will owe $33 in tax, leaving him again with $77 to spend. (Similarly, if the money is left in the bank for, say, five years, it will grow to $112.74 under the interest-exemption approach, while under the savings-deductibility system it will grow to $161.05 before-tax and, again, will allow $112.74 in after-tax spending.)

By itself, the optimal tax is merely an amusing, somewhat instructive exercise in social theory. But the optimal tax perspective of looking at where individuals are at the starting line, rather than at how the race actually turns out, has proven seductive to many consumption tax proponents. They regularly defend their program as consistent with optimal tax principles, except that, instead of assuming everyone starts off equal, the consumption tax supposedly results in "taxing people with equal endowments equally." Thus, for example, Harvard professor William Andrews, one of the giants of consumption tax advocacy, has written that "a consumption-type personal tax can be usefully regarded as the equivalent of a lump-sum tax on wealth," with "wealth being defined to include the present discounted value of all future earnings as well as material wealth."

Based on this putative equivalence, most versions of a progressive consumption tax would grant taxpayers the option of forgoing a tax deduction for their investments in favor of a tax exemption for the income the investments generate. Thus, if Mr. Smith and Mrs. Jones each invest $10,000 and the lucky Mr. Smith becomes a millionaire while Mrs. Jones loses her shirt, each could be taxed the same. The fairness of this approach is self-evident to its proponents, since Mr. Smith and Mrs. Jones started with equal opportunities.

Those consumption tax advocates who find no fairness problem in allowing taxpayers to choose an exemption for their investment income in lieu of a deduction for their investments usually note that availability of the alternative approach should be no more beneficial to taxpayers, nor should it entail any added revenue loss to the government—since rates of return on various types of investments will tend to average out. But on average any tax system is fair, including even the pure lump-sum optimal tax. No matter what the tax code provides, the average taxpayer always will pay the average tax. True fairness, however, is supposed to deal with specifics, not averages.

Suppose the IRS were to announce that henceforth it would flip a coin over every tax return it received. If the coin came up heads, whatever tax had been paid on the return would be refunded. If the coin came up tails, on the other hand, the unlucky taxpayer would have to pay double. This game of chance wouldn't affect the average distribution of tax burdens or, for that matter, government revenues. But it clearly would raise some serious fairness questions. A few consumption taxers, notably Professor Andrews, recognize the problem in the Mr. Smith/Mrs. Jones situation (which is really quite similar conceptually to the coin-flipping example), and would not allow such results to occur under their systems. But the optimal-tax perspective of looking at opportunities rather than actual outcomes permeates the reasoning about equity underlying all versions of the consumption tax.

If you and your neighbor each earn the same income, but, for one reason or another, your neighbor saves a good deal more than you do, he would find a tax on spending advantageous. Consumption tax advocates defend this result by arguing that, since you and your neighbor had equal opportunities to save, you each should pay the same tax on your "endowments." "Equality" for consumption taxers, however, means that the total taxes paid by your neighbor on both his savings and the interest he earns on those savings in the future should be exactly equal in value to the taxes you pay on your consumed income. One way to achieve this "equality" would be to tax both of you on your full incomes this year, but allow your neighbor a permanent tax exemption for the interest he earns (whether he spends it or not). Another approach, the more normal consumption-tax treatment, would be to allow your neighbor a deduction for the money he saved—and to tax it only when (and if) he spends it. The "present discounted value" of each approach is the same.

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Now contrast the consumption tax's "equal endowment" reasoning to the fairness case for the income tax—a tax that focuses on actual outcomes and that eschews averages in favor of specifics. As reflected in the committee report on the 1913 income tax bill quoted earlier, the most often cited theory behind taxing income is that taxes ought to be based on a person's *ability* to pay them. And income, perhaps with adjustments for large medical expenses or catastrophic personal losses due to fire, storm, or other calamity, seems clearly to be a better measure of taxpaying ability than the amount a person happens to spend out of income in a given year. Someone earning $100,000 and spending only $20,000 certainly has greater taxpaying capacity than someone making $20,000 and spending it all. Should they be taxed the same? Yes, say consumption taxers; no, say proponents of the income tax.

Just as the consumption taxers quote Hobbes and Mill for historical endorsements, so do those who favor taxing income claim a distinguished lineage for their approach. Most notably, the first apostle of modern capitalism, Adam Smith, wrote in 1776:

> "The subjects of every state ought to contribute toward the support of government as nearly as possible in proportion to their respective abilities, that is in proportion to the revenue which they respectively enjoy under the protection of the state."

Stanley Surrey recalls how, when he helped design a new Japanese tax system after World War II, the guiding principle was "tax equity, tax fairness—that each strata of society would pay what it was capable of paying." How did Surrey and the other American members of the tax-writing commission determine the "ability to pay" of different "strata" in Japan? They went out and talked to the people:

> "[W]e simply went up and down the street, asking the Japanese such questions as: 'How high do you think your taxes should be? Is the amount of taxes you have to pay now fair? Are they correctly handled? Do you have any suggestions on how to improve the tax system?' "

Those conversations with shopkeepers, farmers, miners, and fishermen led to adoption of a Japanese tax system remarkably similar to the Bradley-Gephardt Fair Tax proposal. Surrey and his cohorts found that "ability to pay" seemed to be a popular and understandable notion to the Japanese people—as it has been to the American public as well. In fact, is is exactly that public appeal that most justifies—and that also limits—the "ability to pay" rule. As it turns out, the case for taxing income is inextricably wound together with public support for using the tax system for redistribution. Professor Alvin Warren, after examining "centuries of elucidation" on "ability to pay" and the income tax, concluded:

> "The argument for the income tax does not appeal to some independently demonstrable principle but is tautological in the sense that it follows simply from the premise of the tax: given a legitimate social concern with the distribution of a society's product, the income tax is justified as a means of effecting the desired after-tax distribution. . . . Society's interest in the distribution of income, in turn, depends on the view that the importance of fortuity and the interrelationships of contemporary society deprive producers of a controlling moral claim to what would be distributed to them in the absence of a tax system."

In essence, Warren's argument is simply a sophisticated restatement of Senator Bill Bradley's more folksy defense of the Fair Tax's operating principle quoted earlier – that "if you manage to do well in this society and to benefit economically, then you should pay a somewhat higher tax rate than those individuals who find themselves struggling from paycheck to paycheck." Warren might have added that the importance of luck and the efforts of others in helping generate the earnings of the big winners under our system is not the only reason for society's interest in redistributing income. That interest also is directly related to the need to reinforce the economic and political structures we have chosen. Neither capitalism nor democracy works well if economic power is too concentrated. And income is almost always a better measure of economic and political power than is consumption, particularly since the income tax reaches corporate earnings while the consumption tax exempts them. (A wealth tax seems to fit this theory as well, and the fact that the estate tax was enacted at about the same time as the income tax reflects this view.)

Under income tax theory, therefore, you, the spender, and your neighbor, the saver, should be treated equally on your equal incomes because you each have the same ability to pay taxes and enjoy similar control over economic resources. A year later, when your neighbor's income is higher than yours due to the interest he earns on his savings, an income tax would ask him to pay more in taxes than you, since his control over economic resources has increased and his ability to pay taxes has become higher than yours. Whether your neighbor is paying a "single tax" or a "double tax," this result seems to square best with what assistant secretary Chapoton forthrightfully concedes to be "most people's conception of equity."

Defining problems away

For many progressive consumption tax advocates, neither economic arguments nor "optimal tax"-style fairness theories are the fundamental source of their discontent with the income tax. Instead, the attractiveness of taxing only spending stems from frustration – both with the political process by which tax laws are made and with the serious difficulties the income tax has faced in curbing tax-shelter manipulations by upper-income Americans.

Frustration with income tax politics is not limited, of course, to those who favor a consumption tax. Reformers of many stripes have long bemoaned the seeming inability of the political process to withstand pressure for more and more loopholes. Sometimes it seems that tax policymakers have no vision of a good tax system in mind at all when they make tax policy decisions. Instead, tax changes are often made on a completely ad hoc basis.

Unemployment is too high? Let's try a jobs credit. We'd like more business investment? Let's install faster write-offs and an investment tax credit. The personal savings rate seems too low? Let's create an "All-Savers Certificate." The public is grumbling about tax unfairness? Let's impose a token minimum tax. And on and on the process has gone.

This ad hoc approach to tax and economic policy has made the tax code an easy prey for special interests seeking backdoor government subsidies, especially those interests that can back up their arguments with campaign assistance. Ways and Means Committee Democrat Andrew Jacobs of Indiana has described the process this way: "If you evade your taxes, you go to the penitentiary. If you want to avoid taxes, you go to the U.S. Congress—and see what they can do for you."

Some consumption taxers believe that, by explicitly establishing a *new* tax paradigm, Congress would become more aware of the dangers of deviating from consistent and "correct" tax rules. Moreover, many consumption tax advocates seem to think that, since their proposal concedes so much to the business lobbying groups that provide most of the pressure for junking up the tax laws, the greed of these lobbies will be satiated.

Realistically, however, this idea—or hope—that a consumption tax would be more immune to loopholes seems a frivolous one. It's hard to imagine that homeowners would gratefully give up their tax advantages merely because we tax spending rather than income. Or that social security recipients would cheerfully agree to pay taxes on half their stipends. Or that charities would be sanguine at losing the benefits of tax-deductible contributions. Or, much more important, that oil companies, timber growers, real estate investors, or any of the other currently favored business interests that often now enjoy outright tax subsidies—or "negative tax rates"—would be content simply to pay at the consumption tax's zero rate on capital income.

Why is it reasonable to assume that, merely by a change in the paradigm for taxation, Congress would lose its zeal to tinker with the economy or favor particular campaign contributors with tax concessions? No currently extant consumption tax proposal includes a Wizard of Oz capable of providing political courage. An exchange between consumption tax proponent Gary Hart and Senator Russell Long in the fall of 1982 illustrates that the consumption tax offers no yellow brick road to ending pressures for special tax treatment:

> Senator LONG. [Senator Hart,] I think you raised an interesting point there that . . . we ought to consider a uniform type deduction . . . when people make investments . . . . Senator Hart, if a person makes a lot of money and does invest it but merely invests in buying real estate, which just tends to bid up the price without putting that real estate to use—he buys land and attempts to move up the land prices that someone else who would like to use it would have to pay—he is not serving society. If he buys the same land and puts it to very active use, he is serving society—

> creating jobs, providing opportunities. In that case I think we would be well advised to try to make the deduction uniform. . . . But if he is not investing that money in ways that are going to benefit the Nation or its people and is only going to benefit himself, offhand I don't see why he ought to have any tax advantage, do you?
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> Senator HART. Senator Long, . . . this [consumption tax] proposal [of mine] says that you only get the tax break if you in fact invest it and invest it productively. Now, the definition of what is "a productive investment" would in my judgment be one of the few possibly lengthy or complicated provisions in the reformed tax code, because clearly you would have to have some technical definition of what was productive investment. Racehorses, Persian rugs, diamonds, and Krugerrands, probably, wouldn't qualify. . . . [Y]ou couldn't just say "savings or investments in anything" because, as you indicated, there are some investments that don't increase productivity at all.
>
> Senator LONG. To a large extent we already have that [approach].

Years of experience obviously have given Senator Long a keen nose for the possibility of "special" tax rules. And his intuition that political life under a progressive consumption tax might not be much different than affairs under the current system has been confirmed in several valuable articles by tax attorneys. The lawyers found sufficient technical shortcomings and enough areas where the consumption tax's inherent resistance to loopholes is likely to be weak to keep the tax lobbying bar occupied in perpetuity. Those consumption taxers who compare a "perfect" progressive consumption tax to the present Internal Revenue Code and conclude that a consumption tax is therefore intrinsically more loophole-resistant than an income tax are indulging in a silly logical error. A day-old banana may be in better shape than a year-old apple, but that doesn't mean bananas are less prone to rot.

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Many progressive consumption tax advocates admit that expecting a congressionally-enacted consumption tax to be free from problems is naive. But they remain persuaded that a progressive consumption tax would be practically superior to the income tax in avoiding the worst kinds of tax-shelter abuses. In fact, for a large number of progressive consumption tax supporters, this supposed feature of the program is its chief attraction.

Tax shelters are essentially investments that pay a higher return after-tax than before-tax. A typical current real-estate shelter, for example, may generate virtually nothing in cash flow for its investors, yet pay them a huge return consisting almost exclusively of tax benefits.

In one or many ways, tax shelters always involve mismatching of profits with tax deductions. One usual type of mismatching involves timing: in the early years of a shelter investment, taxpayers get big write-offs that more than offset the investment's real profits and therefore provide the taxpayers with deductions for artificial "losses." Later, when the deductions are exhausted, the taxable profits from the investment may in turn be artificially inflated, and the taxpayers may be liable to "pay back" the tax benefits they obtained earlier. The effect is similar to an interest-free loan from the government—and the value of such "loans" should not be underestimated. If you could borrow $1 million for five years at no interest, for example, you could pay back the loan at the end of the period and end up with more than $600,000 in your pocket (assuming you could earn 10 percent a year while you hold the money). Or you might ask for an extension of the loan term, as tax-shelter investors in effect routinely do when they roll a "burned-out" old shelter into a fresh new one.

Another type of mismatching common to tax shelters involves using the deductions an investment generates to offset income that would otherwise be taxed at a high rate, while paying tax at a lower rate on the cash flow the investment throws off. A $10 million real-estate shelter, for example will provide its 50-percent bracket investors with $5 million in tax savings from depreciation write-offs over 15 years. If the building or shopping center is then sold for $10 million, the "capital gains" tax on the proceeds will be only 20 percent. This mismatching of tax rates will by itself earn the investors $3 million over the 15 years.

A final key element in tax shelters is that they almost always are financed with borrowed money. The investors is a typical $10 million real-estate deal, for example, will put up only $1 or $2 million in cash. By borrowing the rest, they both magnify their other tax-shelter advantages and benefit from still another kind of mismatching: they can deduct the interest they pay on their loan even though the profits from their investment are sheltered from tax. A simple way to understand this "arbitrage" process is to look at what happens if someone takes out a loan to invest in tax-exempt securities. A 50-percent bracket taxpayer who borrows $100,000 at a 14 percent interest rate and invests the $100,000 in tax-free municipal bonds paying 10 percent may seem imprudent, since he will lose $4,000 a year before-tax. *After-tax*, however, he will make a *profit* of $3,000. The $14,000 a year he pays in interest will be deductible, so that his net interest expense will be $7,000, while the $10,000 a year he earns on the municipal bond will not be taxed.

The bottom line is that the current income tax, by allowing hugely excessive write-offs (and sometimes credits as well) for investments, by granting enormously preferential treatment to capital gains, and by largely ignoring the interaction between these "incentives" and debt-financing, ends up actually subsidizing, rather than taxing, the profits from many types of transactions. Are there viable solutions to these tax-shelter problems under an income tax? The technical answer is probably yes, but implementing those solutions, as the consumption taxers point out, has proven politically and practically difficult.

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Take, for example, the issues that arise with regard to the tax treatment of capital gains. Under a theoretically perfect income tax, inflation-adjusted increases in the value of stocks, bonds, real estate, or other property would be taxed each year, whether or not the assets were sold. And, conversely, declines in asset values would be deductible annually. Given the overwhelming practical difficulties in assessing such unrealized gains and losses (except, perhaps, in the case of publicly-traded stocks), however, the taxation of capital gains and the deductibility of losses is deferred until assets are sold, when gains and losses are measurable with certainty.

This "realization" system creates numerous problems. Not only is the deferral of tax on unrealized gains a substantial loophole in and of itself, but taxpayers can even spend their capital gains without paying any tax by borrowing against appreciated assets with the interest paid being deductible. Moreover, when taxpayers do choose to sell assets and realize capital gains, they can often offset much of their tax by taking advantage of their freedom to realize losses on other investments at the same time.

On top of these advantages, Congress has added two more tax breaks for capital gains: currently, 60 percent of realized capital gains are tax-exempt and unrealized gains in inherited assets are wiped out for tax purposes. The 60-percent capital gains exclusion is usually defended as an incentive for taxpayers to realize their gains and pay at least *some* tax, rather than borrowing against their assets and waiting to sell until they have losses to offset against gains (or till death). Thus, some people argue earnestly that the 60-percent exclusion actually *raises* money for the government, despite the huge tax benefits it appears to provide to upper-income taxpayers.

Whatever one thinks of this argument in isolation, however, it clearly fails to take into account the incentives the exclusion creates for tax shelter gambits whose main purpose is to recharacterize what would otherwise be fully taxable income as "capital gains." The wealthiest Americans–those making more than $200,000 annually–year in and year out manage to have 35 to 40 percent of their incomes treated as lightly taxed capital gains. The key to real-estate shelters, as well as many other tax-avoidance devices, is their alchemic ability to turn ordinary-income lead into capital-gains gold.

In light of all these problems, income tax reformers usually put ending the loopholes for capital gains at the top of their list of needed changes. Eliminating the 60-percent exclusion is the most common proposal, but suggestions have also been made to delay interest deductions for debt used to finance capital assets and even to impose some kind of surcharge on realizations to take account of past deferral benefits. The singular lack of success reformers have had with these proposals is illustrated by the last major change in capital gains treatment–which increased the exemption level from 50 percent to 60 percent.

Despite past failures, however, curbing the tax benefits for capital gains is an essential part of any comprehensive income tax reform program. The Bradley-Gephardt Fair Tax, which would repeal the capital gains exclusion, attempts to get around the usual objection that this would discourage realizations by cutting the top tax rate to 30 percent (and the rate for the vast majority of people to only 14 percent) at the same time.

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Attempts to crack down on capital gains tax breaks and most of the other "investment incentives" provisions in the tax laws are complicated by the fact that many of those "incentives" were adopted in part to try to mitigate serious problems the income tax faces due to inflation. Indeed, inflation has been the Achilles' heel of the income tax–the source of its worst troubles, both real and perceived. As noted earlier, inflation-driven "bracket creep" was the chief catalyst for most of the regressive tax changes that have taken place over the past decade. But bracket creep at least always has been amenable to easy resolution, technically if not politically. The proper measurement of earnings from capital during periods of significant inflation, on the other hand, has proven less tractable.

Suppose, for example, that someone has $100 in a savings account that earns $10 in interest in a year. But over the same period, inflation is 6 percent. The saver's "real" income is only $4, since the other $6 merely keeps the original investment even with rising prices. Yet, under current income tax rules, the saver will be taxed on the full $10. For a 30-percent bracket taxpayer, the $3 tax amounts to 75 percent of the "real" interest. For a 50-percent bracket taxpayer, the $5 tax would be a 125 percent "real" rate.

The same problem can exist with regard to capital gains. If someone buys stock for $100 and it goes up in value to $150 over a period in which prices generally rise by 30 percent, the "real" gain is only $20, and it wouldn't be very fair to tax the whole $50 "profit." Moreover, if someone buys for $100 and sells for $120 after 30 percent inflation, even the 60 percent capital gains exclusion of current law is insufficient to prevent taxation of what really amounts to a $10 loss.

Similarly, if a business invests in equipment that wears out over time, it should be entitled to depreciation allowances that reflect that decline in value. If those allowances are set without regard to inflation, however, they may be insufficient to compensate the business for its true costs.

Now, *on average* the inflation problem is less serious than it may appear. For every lender that is overtaxed on interest income, there is a borrower that is undertaxed by being able to deduct nominal rather than only "real" interest paid. Since most people are borrowing and lending at the same time, the gains and losses from inflation may be roughly offsetting even in many individual cases. By and large, current law, with its plethora of loopholes, hardly taxes "real" capital income at all, despite the overtaxation that inflation sometimes produces. The title of a 1980 study by Eugene Steurle of Treasury's tax policy staff, for example, asked *Is Income From Capital Subject To Individual Income Taxation?* In the aggregate, Steurle concluded, the answer to this question is "no"; the various tax preferences for investment income have effectively wiped out most net taxes on non-wage income.

But inflation does create winners and losers, and an income tax that pretends to be fair has to try to take account of that. Thus, Richard Musgrave, America's leading public finance economist for the past several decades and an ardent advocate of a fair income tax, has concluded that, "[a]s to inflation, there can be no doubt about what the principles of equitable taxation demand. . . . Tax reform calls for inflation adjustment to the largest possible degree."

Unfortunately, adjusting capital income for inflation is not easy. Technically correct rules tend to seem – and sometimes are – quite complicated, and Congress has resisted adoption of such approaches. Ad hoc solutions, such as the 60 percent capital gains exclusion and accelerated depreciation, turn out not only to be too generous in most cases but also to create further, even worse problems, as taxpayers manipulate them to create shelters.

In part because of the technical difficulties in trying to deal with inflationary distortions and especially because of Congress' proclivity to add a new loophole every time the issue is raised, income tax reformers have traditionally disregarded Musgrave's advice on the need for some system of accurate inflation adjustments. The Bradley-Gephardt Fair Tax proposal, for example, addresses the inflation issue only in the area of depreciation, and even there only indirectly. As in the case of capital gains, the Fair Tax's main response to the inflation problem is to reduce statutory tax rates very substantially—a step which really does, however, make the problem far less significant.

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Advocates of the progressive consumption tax argue that the partial answers to the income tax's capital gains and inflation dilemmas offered by Bradley-Gephardt-style reform measures are insufficient, both philosophically and politically. Instead, they maintain, only a radical change in the tax treatment of investment income is capable of truly resolving the capital gains and inflation issues—and thereby truly ending the ability of tax-shelter investors to make a mockery of the tax laws.

Back in the late sixties, Vermont Senator George Aiken suggested a novel way out of the Vietnam War quagmire: declare victory and withdraw. The progressive consumption taxers' proudest achievement—finding a cure-all for the problems of capital gains, inflation, and tax shelters—is similar. They declare victory by defining the problems away—or, more precisely, by abandoning the long-time reform goal of taxing capital income fairly.

Inflationary distortions in measuring capital income are not a problem under the progressive consumption tax because it simply does not tax income. It taxes spending—and spending, by definition, is always current, always in the dollars of the moment. Similarly, under a consumption tax it would no longer be necessary to define capital gains and losses. Taxpayers would get a write-off for the full cost of capital assets, but, if a taxpayer sells an asset and spends the proceeds, the entire amount will be taxable—whatever the gain (and even if there were a loss). Attempts to avoid tax by borrowing against appreciated capital assets and schemes to magnify the tax benefits for investments by "leveraging" would be futile. Borrowed money is added to income in computing taxable consumption. A debt-financed investment would be nominally deductible under the consumption tax, but that deduction would be offset by an add-back for the amount of the loan.

The seeming elegance of the consumption tax's definitional answer to tax shelters is intriguing (and the fact that exempting capital from tax is tougher on tax shelters than current law says quite a lot about the present system). But serious concerns remain. For one thing, the consumption tax's solution is not as technically slick as first appears. How, for example, do we deal with capital gains in things such as vacant land, Persian rugs, and Krugerrands, for which Senator Hart and others don't want to provide consumption tax treatment? What about gamblers—will they be allowed an option either to deduct their bets or to treat their winnings as tax-exempt? Or will we need to run an income tax system alongside the consumption tax to deal with what Congress concludes are unproductive investments? Then there's the sixty-four dollar question of how to handle capital gains and debt during the transition from an income tax to a consumption tax (an issue discussed generally below). And, finally, there's the most fundamental issue:

Is defining savings and investment out of the tax system—whatever the simplification gains—an acceptable approach from a fairness point of view? Despite all the theoretical arguments discussed earlier, few progressive consumption tax advocates really seem to think so. Typically, progressive consumption taxers continue to use income, rather than spending, as their benchmark for measuring tax progressivity, and they say they would impose steep tax rates on high levels of spending in hopes of indirectly taxing high earners on their incomes. Moreover, most progressive consumption tax supporters also recommend beefing up inheritance taxes to deal with the huge individual accumulations of untaxed income that a consumption tax would likely foster.

If taxing income is what we want to do, however, trying to do so through a spending tax seems perverse, especially given the political unlikelihood of the high tax rates and tough inheritance taxes such a system would need to approximate fairness even on its own terms.

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The weakness of the progressive consumption tax's sleight-of-hand solution to capital income taxation problems is most evident when it comes to the corporate income tax – which under the progressive consumption tax would be eliminated entirely.

Under any reasonably fair income tax, a tax on corporate profits is essential. For one thing, exempting corporate earnings from tax would be a windfall for shareholders, who are disproportionately well-off, since they would pay no tax at all until profits are paid out as dividends. In addition, corporations would gain a great advantage over sole proprietorships and partnerships. Of course, these latter kinds of businesses could always incorporate to share in the tax advantages that would exist in the absence of a corporate tax. But this result simply would increase the unfairness to wage earners. (Remember, somebody has to pay the taxes.) In fact, the lack of a tax on corporate earnings could allow virtually any kind of capital income to be indefinitely tax-exempt, since it would be hard to stop people from holding their savings and brokerage accounts within personally-owned corporations. The only unincorporated investments that would exist under such a bizarre system would be those designed to generate artificial tax losses to offset their owners' personal tax liabilities (for example, real-estate tax-shelter partnerships).

Just as fundamental is the role the corporate income tax should play in achieving one of the basic purposes of a progressive income tax – the redistribution of wealth and economic power. An income tax that exempted the largest and most significant accumulations of profits from its ambit would be properly derided as a hoax.

Some income tax reformers, however, have seen a problem in the theory of a separate tax on corporate earnings. While agreeing that taxation of corporate income is appropriate and necessary, they argue that a "double tax," whereby corporate profits are taxed as earned by the company and again when paid out as dividends, is overly burdensome. Under this view, the proper approach would be to treat corporate earnings as the income of stockholders, and to tax a company's owners directly on their share of the corporation's income, whether paid out in dividends or not. In other words, it is said, theoretically corporations should be treated as giant partnerships.

If the idea of treating AT&T as a 3-million-member partnership is not sufficiently mind-boggling in and of itself, however, consider the problems that would arise when shareholders sell their stock during the year. The 3 million people who own AT&T on January 1 may be a quite different bunch from the 3 million who end up owning the company on December 31. Moreover, what happens when, after a corporation reports its income to its shareholders, the IRS determines that the company's accountants made a serious mistake? That's an awful lot of Form 1040X amended tax returns to have to deal with.

Could this problem be solved simply by allowing corporations to deduct their dividend payments? Then the corporate tax would apply only to retained earnings, while shareholders would pay individually on their dividend receipts. Under this approach, however, charities, pension funds, and other tax-exempt holders of corporate stock would receive an enormous windfall. Not only would the revenue cost to the Treasury be very large, but such a rule would allow tax-exempt organizations to conduct tax-free businesses, so long as they were incorporated. Such an enormous expansion of the benefits of tax-free status could create significant competitive problems for taxable businesses, and would be in sharp conflict with long-standing rules that, directly or indirectly, generally subject charities and other tax-exempt groups to taxation on their "unrelated business income."

Still another approach to "integrating" the corporate and personal income taxes would be to grant shareholders a tax credit for the taxes their companies are deemed to have "paid on their behalf." This system would avoid giving away anything to tax-exempt shareholders (which couldn't use the credits), but tax lawyers have discovered it reopens the same kinds of knotty technical issues that are involved in "partnership" treatment of big companies.

Of course, in the current context, worrying about "double taxation" of corporate profits at all is pretty zany. One leading past advocate of "integration," assistant Treasury secretary Charles McLure, recently noted ruefully that his book defending integration had become "instantly irrelevant"—since soon after it was published Congress passed the 1981 Reagan tax act, wiping out most of the corporate tax.

Would we need to worry about integration under a reformed income tax? The Bradley-Gephardt Fair Tax, which would reinstate an honest corporate tax, does not. But the Fair Tax's relatively low rates on both corporate and personal income would substantially mitigate any "double tax" problem. Moreover, it should be noted, adoption of the Fair Tax would be a substantial windfall to companies that had made large investments under the generous rules of the old tax system, with the expectation that future profits might be taxable at relatively high rates (a factor that caused the International Association of Machinists and Aerospace Workers to propose only a gradual reduction in the statutory corporate tax rate in its adaptation of the Bradley-Gephardt program). Were the Fair Tax actually to be adopted, "integration" possibilities might be worth exploring at some point, but it's also reasonable to conclude that the small "double tax" Bradley and Gephardt would retain would not only be tolerable in the interest of simplicity, but would also be beneficial to tax progressivity and to the furtherance of redistributive goals.

The progressive consumption taxers' assertion that they can define savings and investment out of the tax system, yet still achieve fairness goals—at least in the distributional sense—by personal rate adjustments, may have some theoretical appeal with regard to individual tax shelters. But that argument is completely unpersuasive in the case of the corporate income tax. It may be true in some sense, as consumption tax advocates are fond of noting, that "corporations don't pay taxes; people do." The corporate tax may indeed ultimately be passed back to shareholders in reduced dividends or smaller capital gains. But it's equally true, and rather more important, that corporate profits generate economic and political power—power that is not merely the sum of the individual ownership rights of stockholders, but that is unique to the corporate entities themselves. In fact, it's quite obvious that America's *largest* concentrations of economic and political power are in corporate form. A tax system that purports to maintain some checks on that power through changes in individual tax rates simply fails to comprehend a fundamental purpose of redistributive tax policies.

We can't get there, but it hurts to try

Despite all the learned treatises that have been written about the progressive consumption tax, its advocates have yet to hit upon a solution to an overwhelming practical predicament. No one has a clue as to how such a tax system actually could be implemented fairly.

Defining taxable consumption as income minus savings is a clever way to measure an individual's actual spending. But, when it comes to trying to get from where we are to the academic version of a "perfect" progressive consumption tax, it's not clever enough. The transition problem, in a nutshell, involves dealing with old money.

Suppose that a progressive consumption tax really were to be adopted, and on the day it goes into effect Mr. Jones has $10,000 in the bank. How do we treat that $10,000?

1. Do we allow Mr. Jones an immediate $10,000 tax deduction for his existing savings?
2. Or do we ignore the savings for the time being, but tax the $10,000 when and if Mr. Jones withdraws it?
3. Or do we ignore the $10,000 now *and* when it is withdrawn?

Total indifference to existing savings, as under Rule 3, may be the most intuitively appealing approach, since it seems to continue the old income-tax rules under which Mr. Jones originally made his deposit. But Rule 3 turns out in practice to be merely a restatement of Rule 1, which makes all existing savings deductible. Under Rule 3's indifference approach, Mr. Jones could simply withdraw his $10,000 from his bank account and then redeposit it to get the desired deduction. And following the Rule 1 system of making all existing savings deductible would not be a very happy result. It could lead to long-term tax exemption for the very wealthy. Someone with $1 million in savings who is living off the interest, for example, could end up owing nothing in taxes for 10 years (with carryovers of unused deductions), even though he or she consumes $100,000 a year.

To allow no deduction for existing savings, while taxing all withdrawals, as under Rule 2, seems to create the opposite problem. Suppose, for example, that Mr. Jones had put the $10,000 in his savings account out of his after-tax income in years prior to adoption of the consumption tax. This means that the $10,000 has in effect already been taxed. Taxing it again seems punitive, and would be an ironic result of a tax system supposedly designed to favor savers. How would you feel, for example, if you were told that the IRS now claims a right to take 30 percent or so of the $5,000 nest egg you have been building to finance a new car or your child's education?

A sales tax—that is, a direct, flat tax on consumption—implicitly adopts the seemingly harsh Rule 2. And, it could be argued, such an approach might not be so bad under a progressive consumption tax as well. Given the current income tax's many preferences for capital income, on average the supposition that Mr. Jones made his savings deposit out of after-tax dollars is probably wrong.

But, even if one were to dismiss the fairness arguments against taxing all withdrawals from existing savings, in practice it would be difficult to avoid ending up making all existing savings deductible anyway, as under Rule 1. Suppose that a progressive consumption tax really was about to be enacted. Everyone in the country with substantial wealth would be advised by their lawyers to amass as large as possible a store of cash outside of bank accounts or other places where records are kept. Then, when the law took effect, these people would deposit their money back into the bank and take big tax deductions. Such shenanigans could be outlawed, of course, but the prohibition would be very difficult to enforce. Theoretically, the IRS could try to monitor individual consumption and crack down on flagrant discrepancies it detected between actual spending and the taxable consumption reported by taxpayers. But no one thinks that approach is workable. Alternatively, the law could require taxpayers to file balance sheets listing their assets and liabilities as of the day the tax was enacted. Expecting a balance sheet requirement to be politically feasible in a country as concerned about privacy as ours, however, is wishful thinking. Expecting such balance sheets to be honest seems downright Pollyanaish.

Even taxpayers without substantial wealth could manipulate the transition rules that would have to accompany a consumption tax. Suppose, for example, you were to borrow $50,000 the day before the consumption tax took effect. The next day, you pay off your loan. Since loan repayments are deductible under the consumption tax (borrowing is taxable as dissavings, repayments are deductible as dis-dissavings), you would have generated a tax deduction from a meaningless transaction. In fact, why stop at $50,000? On a one-day loan, the sky's the limit.

Now this result, too, could be prohibited, by denying deductions for paying off loans incurred prior to the effective date of the consumption tax. Such a prohibition creates its own problems, however. Suppose that the day before the consumption tax goes into effect, Mrs. Smith has debts totalling $50,000. Suppose that after the tax takes effect, she decides to refinance her debts, to take advantage, say, of a lower interest rate. Will we tax her on the proceeds of her new loan and give her no deduction for paying off her old debts? The cries of unfairness would be justifiably loud. But how do we distinguish "new" borrowing from refinancing? It looks like we're back to the impractical "solution" of balance sheets.

The above discussion only touches on the horrendous transition problems of moving to a progressive consumption tax—problems that undercut the "simple" solutions the consumption tax purports to offer for hard issues such as capital-gains taxation and inflation adjustments. And to these dilemmas, in turn, the consumption taxers suggest only ridiculously complex answers. A leading transition proposal, for example, would require everyone to fill our his or her tax return under both the old income tax rules and the new consumption tax rules for 10 years—and pay whichever amount was higher! Try selling that to the average taxpayer—or to the average congressman up for reelection every two years.

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Given the political and practical unworkability of the progressive consumption tax why should we worry about it? Why has this essay devoted so much space to discussing the idea?

The reason is that the unfeasibility of the progressive consumption tax does not make the concept of only academic interest. Accepting the consumption taxers' theses that the income tax is hurting the economy by discriminating against saving and that there is no inherent conflict between fairness and a tax only on spending, Congress has felt intellectually justified in adding loophole after loophole to the income tax in the name of "incentives" for saving and investment. Over the past year and a half, the Reagan Treasury Department has repeatedly defended various corporate tax breaks as "consistent with consumption tax principles" (based on the apparent theory that *anything* that reduces corporate taxes meets this test). Moreover, academic support for the consumption tax has helped keep the flat-rate value-added tax—the only tax on spending that does not present insurmountable transition problems—on the table as a dangerous, although still remote, political possibility. (As noted earlier, the hidden nature of the VAT helps mitigate its political disadvantages.)

Now, of course, Congress doesn't take its marching orders from academicians and economists, and many—perhaps most—of the problems we currently face in tax policy would exist in the absence of academic support for the progressive consumption tax. Moreover, it's fair to note that most advocates of the progressive consumption tax have loudly decried both congressional loophole fever and the value-added tax as perversions of their beliefs. But ideas do matter in Washington, and the consumption taxers' protests do not absolve them of blame for the predictable political consequences of their actions. They should not lightly shrug off Harvard professor Stanley S. Surrey's charge that "the academic focus on taxes on consumption is both a false route out of our troubled tax picture and itself a cause of that troubled state."

The bottom line view from the Washington tax reform movement is that it's time academicians and economists who are concerned about tax fairness stopped touting the progressive consumption tax as a viable alternative to reform of the income tax. So long as well-intentioned people argue that a progressive consumption tax, by stimulating saving and investment, will help the economy, they are playing into the hands of self-interested corporate lobbyists who claim that inadequate investment is the source of our economic problems and that added loopholes in the income tax are the solution. They are playing into the hands of those who propose a value-added tax or national sales tax as a substitute for progressive taxes. They are playing into the hands of flat-raters and supply-siders who want to abandon fairness as a goal of the tax system. In short, as Stanley Surrey puts it, "they are playing a dangerous political game."

CONCLUSION: INSTITUTIONALIZING TAX REFORM

Is it really possible to throw out the entire tax code and make a new start? Most people who have worked on tax policy for any length of time think not. They point to technical problems, transition issues, and political reality. These experts are not necessarily right, but they probably are.

This makes it of critical importance that the vision of a fair tax system we set for ourselves be one susceptible to incremental achievement, as well as all-at-once adoption. Such a criterion enhances the attractiveness of schemes such as the Bradley-Gephardt Fair Tax—which in essence is a program of closing loopholes and lowering rates. In this volume's colloquium, Senator Bradley points out that the Senate Finance Committee may in fact try to take some steps toward a Fair-Tax-type system over the next several years. On the other hand, an idea like the progressive consumption tax, even if it were desirable in the ideal, fails miserably to meet the step-by-step guideline. The consumption tax essentially involves expanding income tax loopholes for investment, balanced by a sharp crackdown on the tax treatment of borrowed funds. Until the latter step is taken—and it probably never will be—incremental steps toward a consumption tax actually move *away* from *any* ideal, providing the well-advised and the well-off with more opportunities to shelter both their income and their consumption.

When all is said and done, the problems with our current tax code are not philosophical or technical. Most people know generally what a fair tax system would look like and technicians know how to craft the rules to implement such a system. Ultimately, the problems in our tax laws are political, and the solutions to those problems also must be political. In particular, we need to address the institutional imbalance of power between those who benefit from tax loopholes and those who pay for them.

Astute analysts, including the moderator of the colloquium that follows, have written persuasively about the problems created by our system of private financing of election campaigns. Those problems are pervasive and solving them could do much to improve the making of tax policy. But there are other institutional problems that need to be confronted as well.

There are few loopholes in the social security tax because the public clearly sees the link between payroll taxes and social security benefits. There is therefore a huge and deeply interested constituency of senior citizens—and to a large degree their children—who will fight tenaciously to maintain an adequate social security tax. But when an income tax break of enormous value to a particular company or industry is debated, the constituency against granting the preference is diffused and its stake is tenuous. If a technical amendment can give a single corporation $14 billion over ten years, as was true for AT&T in 1981, the company obviously will expend enormous effort to obtain that change. But who will oppose it? Will ordinary taxpayers view the $14 billion loophole as costing them $200 each over the decade and rise up in protest? Will food stamp recipients fear a six or seven percent cut in their allotments and take to the streets? Will the Pentagon be energized into action at the thought that the tax break may cost it the cruise missile? Will potential homebuyers make known their concerns about added deficits and their impact on interest rates? Or will everyone assume that someone else will bear the cost?

"Public interest" groups can try to dramatize the connection between loopholes for some and lost government benefits or higher taxes for others, and sometimes they will be successful. They can appeal to Congress' sense of justice and sometimes prevail. When faced with equal pressures to do good or to do evil, Congress almost always will choose to do good. But, more often than not, the pressures will not be equal.

So perhaps we should be exploring institutional ways to link taxes more directly to government programs or to connect narrow tax breaks more directly to higher taxes generally. To some degree, the congressional budget process is supposed to create these kinds of linkages. And, to some degree, it has been successful. The 1982 tax reform act, for example, was largely a product of that budget process. Faced with a mandated revenue increase target, Congress had to face up to the question of who would be asked to pay higher taxes, and in general it focused on raising taxes on those currently paying too little. But the budget process was co-opted in 1981, when a popular President pushed through his tax cut and defense increase package, and it was ignored in 1983, when that same President successfully fought all attempts to narrow his deficits by either spending cuts or tax hikes.

Imagine, however, that the corporate income tax was earmarked to defense spending. Its erosion would have powerful enemies. If the cost of tax shelters in used shopping centers were offset against HUD's budget for subsidized housing, those tax preferences would attract serious opposition. If tax forms included a line assessing a "loophole surcharge," middle-income Americans might complain a bit louder.

Some tentative steps in this direction already have been taken. The Navy now is required to count in its budget the tax losses involved in leasing rather than purchasing certain ships. For the past few years, cleaning up chemical pollution has been financed through a "Superfund" tax on chemical companies. And presidential candidate John Glenn has suggested what he calls a "pay-as-you-go" plan for federal budgeting, under which proponents of new spending initiatives would have to specify which existing programs would be cut or whose taxes would be raised to offset the cost of the new spending. Presumably, Senator Glenn wouldn't mind extending the pay-as-you-go principle to proposals for new tax loopholes as well.

Earmarking specific taxes to particular programs enjoys little favor among public finance economists. Maybe it's not a good idea. But highlighting the connection between low taxes for some and higher taxes and lost government services for others is not a demagogic trick. That linkage is exactly what tax policy is all about.

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STATEMENT BY NORMAN B. TURE, PRESIDENT, THE INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, WASHINGTON, DC

Mr. TURE. It's a pleasure, Mr. Chairman.

I would like to join my fellow panelists and witnesses offering congratulations and commendations to the committee for undertaking these hearings. I appear as president of the Institute for Research on the Economics of Taxation, but I have to assure you that the remarks I offer are my own and not necessarily those of the Institute.

I think you particularly deserve commendation for your patience in absorbing and listening to such varied testimony on these very difficult matters. Exercises of this sort likely turn out to be extensive exercises in pejorative tax policy, and I will do my best in my few moments here to eschew the pejorative.

I think this is an extremely wholesome kind of event, all the more so because it provides an enormous opportunity for the committee and for the Congress as a whole to examine the fundamental flaws as well as strengths in our existing tax system, to identify what it is that we really want our tax system to achieve for us, and to do what can be done as a matter of practical politics to restructure our tax system to meet those objectives.

My view is that the occasion for tax reform is cast up by the inadequacy of our present revenue system, not by the inadequacy of the aggregate amount of taxes it throws off. I would fervently hope that if the committee and its fellow committee on the House side is to engage in a serious effort at tax restructuring, the objective will not be to raise more revenue but to provide us a tax system which is much more nearly conducive than the present one to efficient operation of the economy.

Let me take a moment to spell out in very simple and general terms what I think that calls for.

We need a tax system which will least impair the efficient functioning of the market system. And that means we need a tax system which will least distort the signals the market system continuously casts up to us about the relative costs and rewards for all the alternatives we face.

We need a tax system which will less bias our decisions against savings and capital formation, less bias our decisions against productive market-oriented work, and less incline us toward consumption and leisure, if you will.

Moreover, we need a tax system which will less distort the market signals about the best way to save and the best way to invest and the best kinds of things to consume and the best kinds of jobs to seek and the best labor conditions.

In effect, in a word, what we need is a tax system that is as nearly neutral, has as little excise effect, as we can possibly design.

What kind of a tax system is that? Well, it is a system which has a very nearly uniform income base which provides the broadest possible exclusion of current saving from that base, and which provides for the fullest possible inclusion of the returns for saving in that base.

It is a tax system which does not impose any tax on corporate entities as such, and it is a tax system which levies on the base I have described the flattest, lowest possible rate structure.

I think that a very large part of the discussions that have taken place in recent times about what kind of tax restructuring we should undertake, those discussions have been unduly constrained by a perceived need to maintain the existing distribution of tax liabilities by income level and as between individual and corporate taxpayers.

I can't think of a less meaningful, indeed a more counterproductive constraint on decisionmaking about tax restructuring than that. I don't know of anybody who likes the present income level distribution of individual tax liabilities. Liberals think we are not progressive enough, conservatives think we were too progressive.

I do not think there is anything highly productive to be found in a so-called pure flat income tax. I think that would accentuate the existing tax biases against saving and capital formation. Most of the modified flat taxes, it seems to me, are best described as grab bag taxes or they lack coherence, and I think they would have many mischievous effects.

Finally, one word. All of us are inclined I think to identify what would be an ideal tax system and hope that we could immediately overleap from here to there. I don't think that describes any possibility in the real world. Rather, I think the constructive and feasible way to approach this is to identify a target ideal tax system, and in a series of steps spread over a number of years try to move in that direction. I think that's what we attempted to initiate in 1981 with the Economic Recovery Tax Act. I'm sorry that we seem to have departed from that course; I hope we can get back to it.

Thank you for your patience.

The Chairman. Thank you.

Mr. Keating? Oh, excuse me.

Mr. Keating. Do you want to hear Mr. Wertheimer first?

The Chairman. That's all right, go ahead, and then I will go to Fred.

Mr. Keating. All right.

[Mr. Ture's written testimony follows:]

Statement
by
Norman B. Ture, President
Institute for Research on the Economics of Taxation (IRET)
to
Committee on Finance
U.S. Senate
August 9, 1984

The Finance Committee is to be commended for holding these hearings on tax reform in response to the surging interest in fundamental restructuring of the tax system. Redesigning the federal tax system presents a serious challenge. If that challenge is to be met successfully, the legislative effort will have to be guided by clearly perceived objectives and criteria for tax revision.

There is, of course, many a slip 'twixt the cup and the lip, and there is no guarantee that the widespread interest in tax reform will result in major legislative action in the near future. One need hardly tell this Committee about the obstacle to any significant restructuring of the tax system, nor remind the Committee that this is not the first time that it has received earnest suggestions for such restructuring. Two things, however, distinguish the current interest in major tax reform from that of the past.

One is the momentum for fundamental tax revision which has developed. I do not recall a time in the postwar era in which so many members of Congress have introduced bills calling for such sweeping alternatives in the present tax structure. This momentum could disappear, to be sure, and the Congress might again enact the kind of tax legislation we've seen in recent years. But the increasing number of congressional sponsors might be hard pressed to explain to their constituents why they retreated from the major restructuring they had proposed to the kind of highly detailed legislation of limited applicability enacted this year and in 1982.

The very magnitude of current and projected federal budget deficits is the second factor distinguishing the current thrust for tax reform from past efforts. Few if any of those now fashioning proposals for major revision of the tax structure cite raising more revenue as one of the objectives they seek. I sincerely hope that any major tax restructuring will not be distorted and warped by using it as a vehicle for raising more revenues. But if the Congress and the Administration are intent on any such counterproductive course, it would be all the more important that the additional revenues were raised in a way which least damaged the economy.

The core objective of any real overhaul of the tax system should be to provide a tax system which permits the U.S. economy to operate as effectively as possible. To achieve this objective, I believe, we need a tax system which least impairs the efficient functioning of the private market system, i.e., which least distorts the market's signals about the relative costs and rewards for saving and investment compared with current consumption and for productive, market-oriented uses of our time, skills, and energies compared with "leisure" uses thereof. We need, moreover, a tax system which to the least possible extent alters the relative costs and rewards for alternative forms of saving and investing, of consumption, and of labor. We need, in a word, the most nearly neutral tax system we can achieve.

To serve this objective, tax restructuring should aim at ultimately attaining the most nearly uniform income base, with the broadest possible exclusion of current net saving, to which the lowest and flattest possible statutory rate structure is applied. No tax would be levied on corporate businesses.

The first of these attributes---the uniform income base from which all current net saving is excluded and in which all of the gross returns on all saving and investment is included---is essential if the income tax bias against saving and investment is to be minimized, if not eliminated, and if tax-induced distortions of the allocation of saving and investment are to be swept away. The low and flat marginal rate structure is required if the income tax bias against market-oriented labor uses of one's time, skills, and energies is to be minimized and if the tax is not to be, in effect, an excise on productivity-advancing activity.

The tax base which most nearly conforms with that I've suggested is described quite well and in considerable detail in the U.S. Treasury Department's 1977 Blueprints for Basic Tax Reform under the confusing title of a "cash flow tax." The economics of this kind of tax are presented in a highly readable book Consumption Taxes: Promises and Problems, which will be published later this month by the Institute for Research on the Economics of Taxation (IRET).

A tax of this sort would be enormously simpler than the existing income tax. It would be far fairer among taxpayers of similar economic circumstances. With an appropriate zero-rate bracket and personal exemptions, it would afford progressive graduation of tax liabilities, i.e., of effective tax rates.

This sort of tax should be distinguished from the so-called "pure" flat tax which would sweep away all features that reduce the amount of income exposed to tax. That sort of tax base would accentuate the existing bias against saving and capital formation by including in the base virtually all current saving and all of the returns on that saving.

The tax I've suggested should also be distinguished from the so-called "modified" flat taxes. It is difficult to characterize these proposed taxes simply because they represent an ad hoc approach to tax restructuring. They are "grab bag" taxes, fashioned by dumping all of the "tax expenditures," "loopholes," "shelters," what have you, into a bag, reaching in and pulling out a fistful to be added to the present base.

The design of these grab bag proposals appears to have been guided primarily by an alleged political requirement to maintain the present income-level distribution of individual tax liabilities and the present split between individual and corporate tax liabilities. I can think of no worse set of criteria for basic tax restructuring. I know of no one who asserts the present distribution of income tax liabilities by income level is just right; liberals want it to be more progressive and conservatives want it to be less so. And defense of any corporate tax liability rests on demagoguery, not on good economic or tax principles.

There should be no illusions concerning the difficulties which would confront replacing the existing tax system with the sort of tax I have suggested. Any once-and-for-all switch would cast up transition problems of such severity and variety as to preclude any economical listing of them. For this reason, I believe there is much to be said for a more gradual approach to tax restructuring, with the target tax clearly in mind as a guide to the tax changes undertaken over a period of years.

This was the approach initiated in the Economic Recovery Tax Act of 1981. As the Committee well knows, that thrust of tax reform was blunted by subsequent revenue-raising tax measures. There is likely to be in the next several years a major opportunity to restore the constructive character of tax reform which the 1981 legislation embodied. Taking advantage of that opportunity requires clear perception of objectives and determination not to allow misapprehensions of the impact of fiscal aggregates on the economy to push us into conterproductive tax revisions.

STATEMENT BY DAVID L. KEATING, EXECUTIVE VICE PRESIDENT, NATIONAL TAXPAYERS UNION, WASHINGTON, DC

Mr. KEATING. Thank you for the opportunity to appear today. I commend you for holding these hearings and for your continued interest in working to simplify the tax system.

We think a well-designed tax reform bill would drastically reduce marginal tax rates and simplify the system by eliminating many, if not all, deductions, exclusions, and credits. A new system should not collect more revenue than we are currently collecting, in our opinion. It would also reduce the tax bias against savings and investment, protect the poorest households from paying any income taxes, and be indexed for inflation.

We support many alternatives to the current system. One of the best proposals we have seen has been offered by two Stanford University economists who have appeared before this committee—Robert Hall and Alvin Rabushka—and I have outlined some of the details of their proposal in my statement.

The flat-rate tax, or steps in that direction, would unleash tremendous economic growth. There would be many other benefits that I have outlined in my statement.

I would like to touch briefly on some of the modified flat taxes that have been proposed, in particular the fair tax offered by Senator Bradley and Congressman Gephardt. We think it is a constructive proposal in the debate. One major flaw that we see is the lack of income tax indexing. In table 1 on page 10 of my testimony I have calculated the tax increases caused by inflation—5 percent over a 5-year period. As you can see, they range from 13 percent up to 64 percent and beyond, depending on your tax rate bracket.

In general, inflation is a regressive tax under the Bradley-Gephardt plan.

The fair tax also fails to repeal deductions for State and local income taxes and real property taxes, which will create distortions at the State level in mixing their revenue base. I don't see any reason to continue deductions for those types of taxes.

They also propose repealing the Accelerated Cost Recovery System and replacing it with something that is very complicated, inefficient, and very sensitive to inflation—something we should try to stay away from.

We think the Kemp-Kasten proposal is a bit more attractive, because it does not have the same inflation caused distortions.

I would also like to say, in conclusion, that we are unalterably opposed to imposing a national sales tax or a value-added tax on top of our current income tax system, or even in partial replacement of it. That regressive tax would add to an already oppressive tax burden in America, and we don't think it is the way to go at all. It is probably one of the few areas where we agree with the AFL-CIO.

We would like to correct one statement that Mr. Oswald said a few minutes ago—that civil service pensions are fully paid for by earmarked contributions. That of course is hogwash; taxpayers are paying approximately 80 percent of the benefits for civil service retirement pensions.

Thank you, and we look forward to continuing our work with you on this subject.

The CHAIRMAN. Thank you.

Mr. Wertheimer.

[Mr. Keating's written testimony follows:]

Statement of

David L. Keating

Executive Vice President

National Taxpayers Union

Summary

The National Taxpayers Union supports simplifying the tax code and reducing marginal tax rates.

The tax laws and regulations cannot be understood by any human being. As a result, too much creative talent is wasted in counterproductive work to minimize taxes instead of creating prosperity.

A well-designed tax reform bill would drastically reduce marginal tax rates and simplify the tax system by eliminating many, if not all, tax deductions and credits. The new system would collect no more revenue than the current system. It would reduce the tax bias against savings and investment. It would protect the poorest households from paying income taxes. It would retain income tax indexing to prevent automatic tax bracket increases caused by inflation. Finally, it would allow citizens to clearly understand how much they were paying in federal taxes.

We can support several alternatives to simplify the system. One of the best proposals to date is a flat rate tax designed by Stanford University economists Robert E. Hall and Alvin Rabushka. The rate for such a flat rate tax should be no higher than 15 percent -- approximately enough to replace projected tax collections from the current income tax system in 1984.

A flat rate tax would unleash tremendous economic growth. Some estimates indicate that a nine percent increase in real incomes can be expected. A flat rate tax would also be simple to comply with, enhance civil liberty, eliminate tax bracket creep, eliminate the marriage tax penalty, increase government accountability and increase personal freedom.

The Bradley-Gephardt "Fair Tax" is a constructive proposal in the tax reform debate, but it needs improvement. One major flaw is that it would repeal income tax indexing. Under the Fair Tax proposal, five percent inflation for five years would cause across-the-board income tax increases ranging from 13 percent to more than 64 percent. The Fair Tax fails to repeal deductions for state and local income and real property taxes. It also repeals the 1981 Accelerated Cost Recovery System and replaces it with a complicated and inefficient system that resembles the pre-1981 rules.

The Kemp-Kasten "Fair and Simple Tax" is similar to the Bradley-Gephardt proposal but is more attractive because it retains income tax indexing, indexes capital gains for inflation, and retains the current depreciation schedules.

Any tax reform measure should be revenue neutral. If the purpose of tax reform is a sneaky way to raise tax revenues, it will lose the support of many fiscal conservatives -- likely dooming the effort for comprehensive tax reform.

The National Taxpayers Union is unalterably opposed to imposing a national sales or value added tax (VAT) on top of, or in partial replacement of, our current tax system. A national sales tax would be the greatest threat to ever attaining a reasonable level of taxation in America. Virtually every European country with a VAT has raised its rates substantially in the last fifteen years.

Mr. Chairman and members of the Committee, I appreciate the opportunity to appear today on behalf of the 140,000 members of the National Taxpayers Union to speak on the subject of tax reform. I commend you for your interest in this important issue and for holding these hearings.

For far too long people have been hesitating over the tax consequences of their investment and career decisions. The tax laws and regulations in their entirety cannot be understood by any human being. As a result, most people can no longer make sound economic decisions based on their own knowledge of the tax laws. So much depends on complying with the trivia of the tax laws that seemingly insignificant decisions can spell the difference between profit and loss.

We strongly support simplifying the tax system. A well-designed tax reform bill would drastically reduce marginal tax rates while eliminating most, if not all, tax deductions and credits. The new system would collect no more revenue than the current system. It would reduce or eliminate the tax bias against savings and investment. It would protect the poorest households from paying income taxes. It would retain income tax indexing to prevent automatic tax increases from being caused by inflation. Finally, it would allow citizens to clearly understand how much they were paying in federal taxes.

One of the most serious and well thought out proposals for the tax reform has been made by the Stanford University economists Robert E. Hall and Alvin Rabushka. This comprehensive reform is breathtaking in its simplicity, fairness and efficiency. It's also the only flat rate tax proposal to date to tackle the issue of the corporate income tax head-on, something that must be a part of any major tax reform.

The Hall/Rabushka proposal rests on four basic principles: 1) All income should be taxed only once, as close as possible to its source; 2) All types of income should be taxed at the same rate; 3) The poorest households should pay no income tax; 4) Tax returns for both households and businesses should be simple enough to fit on a postcard or on one page.

The current personal and corporate income taxes would be replaced with an individual compensation tax and a business tax with the same low rate.

The individual compensation tax would apply to income received as wages, salaries, and pensions (when retired). The fringe benefits and pension contributions would not be taxed when received by the individual because they are nondeductible items under the business tax, and thus are taxed once in that system. The zero bracket amount would be $6,700 for a married couple filing jointly (a standard deduction), $4,100 for a single individual, plus an exemption of $810 for each dependent. No other deductions would apply for individuals. The only deduction that should be considered would be one for charitable contributions or medical expenses that exceed 10 percent of income.

As the authors note, the business tax would apply "equally to all forms of business -- corporate, partnership, professional, farm, rentals and royalties. The base for the taxes is gross revenue less purchases of goods and services and compensation paid to employees. In addition, a capital recovery allowance is deducted for investment in plant and equipment. No deductions are permitted for depreciation, interest or payments to owners in any form." No deductions are permitted for fringe benefits paid to employees, except for pension contributions.

We believe the rate for the Hall/Rabushka tax plan should be no higher than 15 percent, which is approximately enough to replace the projected tax collections from the current personal and corporate income tax in 1984.

There are many reasons for moving toward the Hall/Rabushka simplified tax. I'll outline a few of them.

It will unleash tremendous economic growth. The burden of our tax system is not simply what it collects in revenues, although that burden is certainly high. There is something that economists commonly call the excess burden of the tax, the burden beyond the revenues collected. Unfortunately, our income tax system has a significant excess burden. This is simply a deadweight loss. All citizens are net losers.

Economist Jerry A. Hausman of the Massachusetts Institute of Technology has researched the economic effects of a flat rate tax plan similar to the Hall/Rabushka proposal. He found the total output of the economy due to increased work effort would rise by 6 percent or nearly $1,000 per person.

A NBER working paper released December, 1981 by economists Alan J. Auerbach, Laurence J. Kotlifkoff and Jonathan Skinner found that a "general result is that even a mild degree of progressivity in the income tax system (as measured by the steepness of the marginal rate schedule) imposes a very large efficiency cost. For example, in comparison with an equal revenue porportional income tax, a progressive income tax . . . [similar to our current income tax] imposes an efficiency cost greater than 6 percent of full lifetime resources." In other words, the typical person would be 6 percent richer over his entire lifetime under a proportional tax.

Economists Hall and Rabushka conservatively estimate a 9 percent increase in real incomes when the benefits of their proposal are realized. They "take Hausman's estimate of a 6 percent increase in output from increased total work in the U.S. economy." They also estimate "a modest additional increment to total output of 3 percent from dramatically improved entrepreneurial incentives."

The clear implication from these and other studies is that a flat rate tax system holds the potential for tremendous gain in economic efficiency and wealth creation.

The poorest people would benefit doubly under the Hall/Rabushka proposal. They would benefit from greater economic growth caused by a more efficient tax system and by not paying income taxes.

One can examine various econometric models to try to get rough approximations of the efficiency cost of the current tax system. But through observing our society, it is clear that there is a large efficiency cost imposed by our current tax system. Some of the nation's most talented people are making tremendous sums of money advising large corporations and rich people how to reduce their taxes. They contribute little to the well-being of all Americans. They are exploiting, mining if you will, the loopholes in our current tax system. Abolishing the current tax system and replacing it with the Hall/Rabushka flat rate tax would put these people to work meeting human needs and consumer demands.

A flat rate income tax would be simple to comply with. If the tax laws were simple enough so that virtually everyone could understand them, few people would pay for advice to fill out their tax forms. Even if they did pay accountants or lawyers to compute their taxes, the fee would be far smaller than it is today.

A flat rate tax would enhance civil liberty. There has been growing concern recently with the Internal Revenue Service's powers. Concerns from the early 1970s stemmed from people's fear of abuse of IRS powers against political enemies. Today those fears have been largely put to rest, but many people are still afraid of the IRS. There is good reason to be. There are fewer civil liberty safeguards on the IRS than virtually any other government agency. There is also wide discretion in the hands of the IRS auditors on how vigorously to pursue tax collections. Evidence points to the existence of quotas in many areas.

There are very few people who can say with absolute certainty that they have not violated some provision of the Internal Revenue Code. This uncertainty accounts for much of the fear.

With a flat rate tax system, the fear of an audit would go down dramatically. The potential for harassment and abuse of IRS powers would also be drastically reduced. Because the laws would be simple, there would be little discretion on the part of the IRS agents. This is an important improvement in civil liberties. With a simple system, fears of using the Internal Revenue Service for political purposes would be permanently banished.

A flat rate tax would eliminate tax bracket creep. The effects of bracket creep are well known: When workers receive an increase in pay to keep pace with inflation, they are pushed into a higher tax bracket, thus paying a greater percentage of their income in taxes. Workers are left with less real income than they had before the pay raise.

Income tax indexing will begin in 1985 under the provisions of the Economic Recovery Tax Act of 1981. Pessimists have speculated, with good reason, that indexing may be modified or watered down. A flat rate tax could not suffer the same fate. Since there is just one bracket, you couldn't be pushed into a higher tax bracket by inflation. However, we strongly recommend indexing the basic personal exemption and zero bracket amount under any flat rate tax.

A flat rate tax would eliminate the marriage tax penalty. The so-called marriage penalty tax refers to the fact that married couples filing a joint return usually pay more in taxes than the combined amount they would have paid had they remained single. The Economic Recovery Tax Act only partially corrected this marriage tax penalty. A flat rate tax would eliminate the marriage tax penalty by addressing the problem at its source: differing tax rates for people with different filing statuses.

A flat rate tax would increase government accountability. A simplified flat rate tax would make the cost of government better understood. Citizens could more easily evaluate how well their government was functioning as well as whether a proposed new program would be worth the tax increase.

A flat rate tax would also increase accountability at the state and local government level. People who itemize deductions almost always take a deduction for state and local taxes. This makes the burden of these taxes less for those who itemize. State and local government programs should stand on their own merits without a federal tax deduction.

A flat rate tax would increase personal freedom. Personal economic decisions are made at the margin, where people are now facing much higher marginal tax rates. The percentage of taxpayers facing a marginal tax rate of 30 percent climbed from 5.4 percent of all taxpayers in 1970 to 34 percent of all taxpayers by 1981.

At the same time the average, or effective, tax rate paid by taxpayers hasn't increased as dramatically. The reason is the ever-greater amount of tax deductions and credits permitted. If you jump through the proper tax loopholes, you'll be rewarded with a lower tax rate. If you choose to live your life the way you please, you'll be penalized with a higher tax rate. A flat rate tax would be neutral in this regard. You could spend your money as you pleased without worrying about the tax consequences.

Winners and Losers

Much will certainly be made about who among taxpayers will be the winners and losers under a flat rate tax. Under the Hall/Rabushka flat rate tax, I believe the answer is that everyone will be better off.

Milton Friedman perhaps said it best in a Newsweek column. "The poor would pay less tax because of high personal exemptions. Many in the middle class would pay less tax because of the lower rate. Others in the middle class and the rich would pay more tax to the government yet be better off. They would pay more because the lower rate would render present costly tax shelters attractive. They would be better off because they gain from being free to use their assets in the most productive instead of the most tax evasive way would be larger than the extra tax . . . [those who fail to understand this do not] recognize how large a wedge there is between the taxes paid and what it costs taxpayers to pay and avoid or evade taxes."

The rule of thumb is that those who would pay more tax are those who are aggressively sheltering their money through tax shelters and deductions. Those who would pay less are mostly those who file a short form or do not aggressively shelter their income. Those in the middle class who may pay slightly more tax will find more than offsetting gains from increased economic growth, reduction of the excess burden of taxes, reduction of the time and effort of keeping records and filling out tax forms, reduced fear of IRS audits, and all the other benefits outlined above. In addition, many taxpayers would take comfort knowing that every other person is paying their share.

The Transition to a Flat Rate Tax

Probably the biggest problem to moving toward a flat rate tax is getting there from here. We should not discount the economic problems involved for some people. Many people have arranged their finances to explicitly take advantage of their current income tax system. A quick move toward a flat rate tax could cause considerable economic dislocation and hardship for these people.

I can think of several possibilities for making the transition. One possibility would be to allow people to opt out of the personal income tax system into the flat rate tax system immediately. Those who felt that it was worth the change could change immediately. Once they were in they would have to stay in.

Alternatively, individuals and businesses could calculate their taxes under the current system and under the Hall/Rabushka system. For example, in the first year one would take 85 percent of the liability under the current system and 15 percent under the Hall/Rabushka calculation and add the two to determine the tax liability. In the second year the tax would be 70 percent for the current system, 30 percent for the new system, 55 percent, 45 percent, and so on.

This approach is similar in concept to design of a minimum tax as a method to reach a flat rate tax system. Either would have the effect of washing out the various methods employed today to shelter income to escape tax.

The Bradley/Gephardt "Fair Tax"

A proposal that has attracted considerable attention is the bill introduced by Senator Bill Bradley and Representative Richard Gephardt. Senator Bradley has repeatedly said that his bill is subject to revision and that he encourages suggestions. We are encouraged by the interest in lowering tax rates but have serious reservations about several of the bill's features.

A major flaw in the proposed bill is the repeal of income tax indexing. The lack of indexing was a major factor in making our tax system such a mess. Marginal tax rates steadily rose as inflation put people in higher tax brackets while Congress took many of the revenues and steadily enacted more tax loopholes. We now have a narrower tax base and higher tax rates.

If Senator Bradley's bill becomes law, taxes would automatically rise as inflation erodes the value of the personal exemption and the zero bracket amount while and boosting taxpayers into higher tax brackets. To prevent taxes from increasing, Congress would have to pass a tax cut bill every few years. At that time there will be renewed opportunities for additional tax loopholes to be created, and marginal tax rates may well rise again. Eventually, most taxpayers may find themselves in the top tax rate bracket of 30 percent. We could not support his bill without indexing.

Senator Bradley claims that he would repeal income tax indexing "because the new rate structure will greatly reduce the problem of 'bracket creep.'" That is incorrect. As Table 1 shows, bracket creep remains a problem under the Bradley/Gephardt "Fair Tax." If inflation runs at 5 percent for five years a family of four earning $15,000, with one wage earner and whose income keeps pace with inflation, will find their income taxes 63.8 percent higher than if the tax system had been indexed. A similar family making $25,000 would find their taxes 17.6 percent higher, while the family earning $40,000 would find their taxes 34.2 percent higher.

Table 1

Increase in Taxes Caused by Five Years of Tax Bracket Creep
Under the Bradley/Gephardt "Fair Tax"
Family of Four, One Wage Earner

1984 Adjusted Gross Income	1989 Adjusted Gross Income	1989 Tax Due	1989 Indexed Tax	1989 $ Increase	1989 % Increase
$10,000.00	$12,762.82	$218.79	$0.00	$218.79	N.M.
$15,000.00	$19,144.22	$1,112.19	$678.98	$433.21	63.8%
$20,000.00	$25,525.63	$2,005.59	$1,572.38	$433.21	27.6%
$25,000.00	$31,907.04	$2,898.99	$2,465.78	$433.21	17.6%
$30,000.00	$38,288.45	$3,792.38	$3,359.17	$433.21	12.9%
$35,000.00	$44,669.85	$5,246.16	$4,252.57	$993.59	23.4%
$40,000.00	$51,051.26	$6,905.33	$5,145.97	$1,759.36	34.2%

Source: National Tapayers Union staff computations. All calculations assume that the proposal became effective in 1984 and that the annual inflation rate for 1984 to 1988 was a constant 5 percent. Calculations also assume that income is from wages, that the 1984 income grows at the annual inflation rate, and that no itemized deductions are claimed.

Inflation has a regressive effect on taxpayers under the Bradley/Gephardt proposal. Because the tax rate brackets are so widely spread apart, every taxpayer in the standard 14 percent tax rate bracket finds that the income tax increase caused by inflation is the same dollar amount. For example, after two years, the family of four earning $15,000 finds their taxes $160.72 higher, as does the family of four making $35,000. That's an increase of 27.4 percent for the lower income family, but an increase of only 4.4 percent for the higher income family.

The bill is also flawed because it allows an unlimited deduction for home mortgage interest but no other types of personal interest expenditures. Many homeowners could evade this restriction by borrowing against the equity in their home to finance something else and deduct the interest. This problem could be reduced by placing a cap on the maximum amount of mortgage interest allowed.

They would also allow deductions for state and loca' income and real property taxes. This is something that is relatively constant from person to person and can easily be repealed without doing much harm. It's also a good idea to repeal this deduction in order to increase accountability for state and local governments.

It is illogical to propose repealing the state and local sales tax and personal property tax deduction, but not the income and real property taxes deductions.

Finally, they allow a deduction for employee business expenses. One wonders how necessary these expenses are if the employer will not pay for them.

If these provisions were repealed or limited, tax rates under the Bradley/Gephardt plan could be reduced further.

The Bradley/Gephardt bill increases several types of taxes on savings. For example, the maximum capital gains tax rate is increased from 20 percent to 30 percent. They also propose repealing the 1981 Capital Cost Recovery Schedules, and replacing them with a complicated system that resembles the pre-1981 rules. Although the current corporate income tax system cost recovery schedules and credits leave much to be desired, it is preferable to the Bradley/Gephardt proposal.

The Kemp/Kasten "Fair and Simple Tax" (FAST)

A recent entry into the tax reform debate is the "FAST" tax proposal offered by Congressman Jack Kemp and Senator Bob Kasten. Congressman Kemp says "the two proposals [the "Fair Tax" and the "FAST" tax] are broadly similar in many important respects. Both bills are designed to broaden the existing tax base, to simplify the tax code and to permit significantly lower marginal tax rates."

But there are significant differences in the two proposals. Unlike the

Bradley/Gephardt proposal, the FAST tax proposal retains income tax indexing, slightly reduces the maximum capital gains tax rate, indexes capital gains for inflation, and retains the current depreciation schedules while lowering the business tax rate to 30 percent and providing a special reduced 15 percent tax rate on the first $50,000 of income for small businesses. Expensing of up to $10,000 per year of business property is added, while the investment tax credit and most other corporate tax preferences are eliminated. It is a more appealing modified flat rate income tax proposal than the "Fair Tax."

Revenue Neutrality

Treasury Secretary Donald T. Regan indicated in a May 21 speech to the National Tax Association -- Tax Institute of America -- that he believes that the tax reform measure should be revenue neutral and that tax raising, if necessary, should be addressed in a separate bill. We wholeheartedly agree that the two issues should be separate. Tax reform will be politically difficult. Special interest groups whose tax breaks will be reduced or eliminated can be expected to wage a hard and difficult fight against a comprehensive tax reform measure. If the purpose of tax reform is to raise tax revenues, it will lose the support of organizations such as the National Taxpayers Union and many fiscal conservatives in Congress. That would likely doom an effort for comprehensive tax reform.

National Sales Taxes

Another proposed reform is the national sales tax or the value-added tax (VAT). Under a VAT, goods and services would be taxed on the market value added at each step of their production. The entire tax is reflected in the purchase price of the finished product, and the effect is similar to a sales tax.

The VAT is much like a common sales tax regarding the distribution of the tax burden -- that is, the VAT is a regressive tax. Though it is equitable in the sense that persons at the same income level would generally pay the same amount of tax, as in any regressive tax system, a heavier tax burden falls on lower and middle income groups.

Some proponents of the VAT recognize the adverse aspects of its regressivity and have suggested measures to correct the problem. One suggestion is to exclude "necessities" from the tax. Food, for example, would not be taxed. This solution leads to another problem -- restricting the tax base. A VAT with exemptions would require higher rates in order to raise the same revenues as a VAT without loopholes. Variable VAT rates could help alleviate the regressivity with a low tax on food, and a high tax on luxury items, but this, too, is complex to administer.

The VAT has been in use in many European countries since the late 1960s and early 1970s. Most of the European nations which have a VAT have a variable rate VAT, as noted in Table 2.

Table 2

European VAT Rates, July 1979

	Date of Implementation	Standard Rate	Reduced	Luxury
Austria	1/1/73	18%	8%	30%
Belgium	1/1/71	16	6	25
Denmark	3/7/67	20.25	-	-
France	1/1/68	17.6	7	33.33
Germany	1/1/68	13	6.5	-
Ireland	1/11/72	20	10	-
Italy	1/1/73	14	9-12	35
Luxembourg	1/1/70	10	5	-

Netherlands	1/1/69	18	4	17.5
Norway	1/1/70	20	-	-
Sweden	1/1/69	20.6	10.3	-
United Kingdom	1/4/73	15	0	-

Source: "The Impact of Consumption Taxes at Different Income Levels," p. 58, OECD, 1981.

Variable rate systems are hard to administer because every product must be placed into a tax category. All of the European nations have different definitions of "luxury rate" items and "reduced rate" items which indicate that it is difficult to agree to what items should be taxed at which level. It's difficult for the consumer to know the tax rate on the item he is buying.

Of the European nations listed above, the average standard VAT rate is 16.87 percent. The average reduced rate is 6.78 percent and the average luxury rate is 28.17 percent. A sales tax of these proportions in America would greatly add to the existing tax burden.

The VAT would have immediate and substantial side effects. By placing a tax on all goods and services, the price of goods would go up dramatically.

Because the VAT is built into the price of a product, proponents say it is a "painless" tax. This type of hidden tax, though, is in direct conflict with the taxpayers' right to know exactly how he is being taxed and what is being taxed. A consumer should be able to see the amount of tax which is levied on the goods or services he buys -- especially under a variable-rate VAT, because different tax rates would apply to different types of goods. Under a regular sales tax, the amount of tax is printed on the receipt. But with a VAT, the consumer does not know exactly how much tax he is paying because the tax is included with the price.

A simpler federal retail sales tax would eliminate the problems of invisibility and administrative complexity. The problems of regressivity and sharp sudden price increases remain, however. The VAT and especially the federal retail sales tax both conflict with the existing state and local sales tax systems. They move the federal tax system into an area which has traditionally been reserved for the states.

The National Taxpayers Union is unalterably opposed to a national sales tax or value added tax unless another tax currently being levied were abolished. We would also likely require that it be constitutionally prohibited.

A key reason for our opposition is that a value added tax or national sales tax will simply become a huge additional source of revenue for the federal government. Reducing other tax rates to be replaced by a value added tax would not meet with our approval either. For example, former Congressman Al Ullman's 1979 tax restructuring act would have used the receipts from a value added tax to reduce Social Security and personal income taxes. However, under Ullman's proposal, inflation would have eventually boosted taxpayers into higher tax rate brackets, gradually replacing the revenues lost by his proposed reduction in income tax rates. There would also be nothing to stop Congress from later raising the Social Security or personal income tax rates to the levels that previously existed.

A national sales tax could be the greatest threat to ever attaining and retaining a reasonable level of taxation in America. Here, the European experience is instructive.

The actual VAT rate would probably rise -- increasing the amount of money available for the government to spend. Table 3 shows how European VATs have risen since their implementation.

Table 3
Increases In VAT Rates

	Year of Implementation	Standard Rate That Year	Standard Rate As of 1/8/79	Increase (%)
Austria	1973	16%	18%	12.5
Belgium	1971	18	16	-12.5
Denmark	1967	10	20.25	102.5
France	1968	16.66	17.6	5.6
Germany	1968	10	13	30.0
Ireland	1972	16.4	20	34.1
Italy	1973	12	14	16.7
Luxembourg	1970	8	10	25.0
Netherlands	1969	12	18	50.0
Norway	1970	20	20	0
Sweden	1969	11.1	20.6	85.6
United Kingdom	1973	10	15	50.0
Average		13.3	16.9	24.8

Source: "The Impact of Consumption Taxes at Different Income Levels," p. 60, OECD, 1981.

The average European VAT rate rose from 13.3 percent to 16.9 percent in less than 15 years. This is a 25 percent increase in the actual rate of taxation. Ten out of 12 European nations increased their VAT rates. The potential for the United States to follow suit under a VAT seems quite likely. The VAT, then, merely becomes an additional source of revenue for the government.

It's worth noting that tax collections as a share of the gross national product is higher in all of these countries listed in Table 3 than it is in the United States.

Because taxes are still at near record high levels, we strenuously oppose raising taxes. The real source of the growing federal deficit has been the continued real growth of federal spending, which is outlined in Table 4. Unless federal spending is brought under control, we can expect continued high federal deficits.

Table 4

The Continued Real Growth of Federal Spending
(Dollar Amounts in Billions)

	1979	1980	1981	1982	1983
Federal Spending (Including Off Budget Items)	$503.5	$590.9	$678.2	$745.7	$808.3
% Increase Over Previous Year, Adjusted For Inflation	1.4	6.5	4.2	2.6	4.2
% Increase Since 1979, Adjusted For Inflation		6.5	10.9	13.7	18.5
Federal Spending, Percent of GNP	21.4	23.0	23.6	24.6	25.0

Amnesty

I urge the Committee to seriously consider instituting a taxpayer amnesty program as part of a tax reform package. This would be a good time to institute an amnesty program. The publicity which will accompany institution of the new tax reform system would also help bring attention to its amnesty provisions.

A taxpayer amnesty program would help boost tax compliance, while also helping taxpayers. A properly designed amnesty program would benefit the IRS by bringing in untold billions of dollars from the underground economy into the light. The non-filer problem could be significantly reduced.

No doubt there are many taxpayers who would like to surface, but are scared about what the IRS might do to them. An amnesty program would allow taxpayers to voluntarily disclose past due taxes without worrying about criminal prosecution and jail. A penalty and interest charge could still apply.

Here are some key provisions that should be included in any amnesty plan:

1) Taxpayers seeking amnesty must not have already been contacted by the IRS for non-filing or for under-reporting;

2) Interest could be charged on back taxes. Penalties might apply, but it would be better if they were waived, save for the failure to pay penalty at 6 percent;

3) Taxpayers who came forward under the amnesty program should be allowed to enter into liberal installment agreements to pay their back due taxes, and, if appropriate, be eligible to have their tax liability waived if it is judged that it would be impossible to pay;

4) The IRS should not share amnesty tax returns with any other federal government agency for the purpose of discovering other violations of the law;

5) The IRS should not share its amnesty tax return information with any state or local income tax revenue authority. Otherwise, taxpayers might open themselves up to prosecution at the state and local level by disclosing their federal violations to the IRS;

6) Taxpayers who have filed fraudulent returns would not be eligible for the amnesty program.

Other, more limited proposals for amnesty have been made, and they would be worthwhile too.

There is, evidently, a de facto voluntary disclosure amnesty policy which is known to sophisticated attorneys who specialize in tax fraud cases. But it's doubtful that the typical citizen is aware of such a policy. Instituting an amnesty program would end this double standard.

An amnesty program would probably generate at least $7 billion of new tax revenue. It would also help insure against a possible loss of tax revenues from an inaccurately low estimate of the revenues likely to be generated under the tax reform plan. The additional revenues generated may also be used to reduce tax rates further.

Conclusion

A flat rate income tax reform would have many economic and social benefits. Many of the intermediate modified flat rate tax reform proposals would make substantial progress in simplifying our tax system and could serve well as an intermediate step. We strongly encourage the Committee to continue its work in developing a comprehensive tax reform plan and stand ready to assist you in these efforts.

STATEMENT OF FRED WERTHEIMER, PRESIDENT, COMMON CAUSE, WASHINGTON, DC

Mr. WERTHEIMER. Thank you, Mr. Chairman. We appreciate the opportunity to be here. We congratulate the committee for continuing these ongoing hearings that it has been holding.

As others have noted, we share the belief that there is widespread and deep public dissatisfaction with the fairness of the tax system. At the heart of that dissatisfaction is a system that seems to provide various special breaks for some people at the expense of most people.

The budget deficits now facing the country are going to require the executive branch and the Congress to carefully look at the entire budget in 1985, and that will include the revenue side of the budget and the expenditure side of the budget. It will increase public focus on the tax system, and it will increase public focus on the fairness question—a question that has only risen in public concern in recent years.

It is also going to place this committee in the center of the issue that will most likely dominate—the domestic issue that will most likely dominate—the Congress and the country in 1985, no matter what the results of the election are.

We believe that progress has been made in the last couple of years in the tax bills passed in 1982 and this year by the committee, but we believe a much more fundamental change is needed.

We believe the general approach set forth in Bradley-Gephardt provides a major breakthrough in creating a framework for looking at a new tax system that can be simpler and fairer and more efficient. And for that reason, we are supporting the general approach of Bradley-Gephardt. We have not committed ourselves to all the details of it; we are concerned, for example, about the fact that it accepts the progressivity contained in the present tax system. We believe in the principle of progressivity and believe that efforts should be made to restore progressivity that has been lost in recent years.

We recognize the great difficulties involved in this kind of battle. We recognize that it involves a classic war of the parts against the whole. We understand the kinds of pressures that exist in the political system and that this committee constantly faces.

We believe the Bradley-Gephardt approach, using it as a framework, creates an opportunity for fighting a battle that must be won if we are ever to begin restoring public confidence in the fairness in the tax system.

Thank you, Mr. Chairman.

[Mr. Wertheimer's written testimony follows:]

STATEMENT OF FRED WERTHEIMER
PRESIDENT OF COMMON CAUSE

Mr. Chairman and Members of the Committee:

I am grateful for the opportunity to appear today on behalf of Common Cause to speak about the urgent need for fundamental reform of the federal tax system.

We last testified on tax reform before this committee nearly two years ago. The widespread public dissatisfaction with the fairness of the federal tax system that was apparent then is at least as great today -- and probably even greater. It shows up not only in national opinion polls, but in the Internal Revenue Service's disturbing reports about the public's increasing willingness to evade taxes. Unless we act soon, we will find that confidence in and compliance with our tax system has been irreparably eroded.

The enormous budget deficits now facing the government are the new factor in the present situation. The pressing need to reduce those deficits makes it imperative that the Congress and the Executive carefully examine all aspects of the federal budget, including both expenditures and revenues. In this situation it is all the more important that we establish a simpler, fairer tax system.

The tax bills passed this year and in 1982 have helped to improve the tax system in some ways, but those improvements are modest in relation to the size of the problem. Much more fundamental, far-reaching reforms will be required to reduce the complexity and unfairness that are undermining public support for the present system.

We believe the general approach contained in the Fair Tax Plan developed by Senator Bradley and Representative Gephardt represents a crucial breakthrough in the efforts to achieve fundamental tax reform. Their plan calls for simultaneously broadening the tax base and lowering marginal tax rates, but maintaining a progressive rate structure. Each of these features is important:

- o First, broadening the tax base -- that is, abolishing many of the deductions, exclusions, exemptions and credits in the present tax code -- would help to simplify the tax system, increase fairness, and lessen economic distortions. The increase in fairness is especially significant: with fewer opportunities for tax avoidance, it becomes more likely that taxpayers with equal incomes will pay the same amount of tax. Abolishing the special tax treatment for long-term capital gains is particularly important in this regard.
- o Second, reducing marginal tax rates would lessen the value of tax preferences, thereby reducing inequities and distortions that exist under the present system. Lower rates also may reduce disincentives to economic growth and productivity. However, claims that lower tax rates will stimulate economic growth appear to have been greatly exaggerated in the past, and should be examined with care. Tax rates are only one of many factors that affect the decisions of individuals to work, save and invest.
- o Third, maintaining a progressive rate structure means that those individuals who receive the greatest rewards under our system will continue to pay a greater share of their income in tax than those who are less favored. We believe this is a sound principle, long accepted by the American people, and should be maintained.

According to an analysis conducted by the Joint Tax Committee staff, the Bradley-Gephardt plan as currently proposed would maintain generally the same distribution of tax burdens by income class as exists under the present law. That is, even though particular individuals in an income class might pay more or less tax than they do now (depending on how much they benefit from tax preferences in the present system), all the individuals in that income class would together bear roughly the same share of the tax burden as they do at present.

We commend Senator Bradley and Represenative Gephardt for maintaining the principle of a progressive tax system, as compared with flat-tax proposals that would shift a significant portion of the tax burden from upper income to middle income taxpayers. We also favor the rate structure of their plan compared with that proposed by Senator Kasten and Representative Kemp in their recently introduced Fast and Simple Tax Plan. According to a preliminary analysis, the Kemp-Kasten plan is more progressive than the present system at the lower end of the income distribution but considerably less progressive at higher income levels, giving a substantial tax cut to individuals with incomes over $100,000.

We are concerned, however, that the Bradley-Gephardt plan accepts the progressivity of the present tax system. We do not think it should. Rather, we think that any effort to overhaul the tax system should seek to restore the progressivity that has been eroded by recent changes in the tax code, especially by the 1981 tax bill.

This loss of progressivity is most apparent when looking at the tax treatment of people at the high and low ends of the income distribution. While wealthy people have benefited from new opportunities to shelter their income and from substantial cuts in the maximum rates on unearned income and capital gains, certain key features of the tax system for poor people have not been changed. Though eroded by inflation, the zero bracket amount, personal exemptions and the earned income tax credit were not increased by either the 1981 or 1982 tax bills, and only the earned income credit was increased in the 1984 bill. The result has been a growing tax burden imposed on people whose incomes are at or below the poverty line.

Consider, for example, a family of four with an income equal to the official poverty level. According to a report by the Joint Tax Committee staff, in 1978 this family would have paid no income taxes, but instead received an earned income tax credit of $134. The credit would have helped offset part of the $403 in payroll taxes paid by the family, leaving a net federal tax burden of $269. In 1984, however, a family of four at the poverty level will pay an estimated $383 in income taxes, with payroll taxes bringing their total federal tax burden up to $1076 -- an increase of 300 percent from the 1978 level.

These findings contribute to our strong belief that it is not enough to maintain the current level of progressivity. We must go further in overhauling the tax system and seek to restore the progressivity that was lost when recent tax changes unduly favored upper income taxpayers. As currently proposed, the Bradley-Gephardt plan does help to reduce the taxation of most poverty-level families, but it only maintains the progressivity of the present tax system above these levels.

Another area in which we have reservations about the Bradley-Gephardt plan relates to corporate taxes. As we understand it, the Bradley-Gephardt plan for corporate taxes would yield about the same amount of revenue as the present corporate income tax. Thus, although the Bradley-Gephardt plan would reduce the disparity in effective tax rates imposed on companies in different industries -- a decided improvement over the present corporate tax -- we do not think it goes far enough in taxing the corporate sector.

We say this in light of the fact that the share of the federal government's revenues from the corporate income tax has declined dramatically over the past twenty or thirty years. As recently as 1966, the corporate income tax provided over 23 percent of total federal revenues. In 1983, however, it accounted for less than seven percent. Even with the economic recovery of the past year, corporate taxes are expected to yield only about 10 percent of the government's revenues in 1984.

There are various reasons for this sharp decline, including the lower profitability of corporations in recent years, but one major reason appears to be the highly generous tax breaks that corporations have obtained. These include the investment tax credit and the Accelerated Cost Recovery System, plus a host of tax breaks specially tailored for particular industries. The result has been virtually to abolish the corporate income tax for favored industries and to greatly diminish its importance as a source of federal revenues. We do not believe this is the right thing to do, and we urge that the Committee reexamine the present division of the tax burden between individual taxpayers and corporations.

Despite these particular reservations, we believe that Senator Bradley and Representative Gephardt have developed an extremely important framework for creating a fairer, simpler and more efficient system to distribute the tax burden. While their plan needs further refinement, it offers an excellent general approach to restoring public confidence in our nation's tax system.

No one likes paying taxes, but people dislike it less if they are confident that others are also paying their fair share to support the government. On behalf of Common Cause, I urge you to keep the issue of fairness uppermost in your minds as you continue your deliberations. Dealing with the nation's budget problems is likely to require sacrifices from all of us in the years ahead, and those sacrifices will be willingly borne only if they are fairly distributed.

Senator PACKWOOD. Thank you, Fred.

Mr. Ellentuck, you are next. I wonder—I don't know what the vote situation is going to be. Bob has gone to vote, and I am going to have to leave when he gets back. But I wonder if in your statement you would mind elaborating on something you say on page 3.

> We believe that many more Americans would feel less imposed upon by taxation if responsible parties included in their public pronouncements that taxes represent a lesser percentage of the United States Gross National Product than is true in most other industrialized nations.

I may get a chance to ask you some questions on that, but I may be gone when you leave; I'm not sure.

Go right ahead. If you could expand that, I would appreciate it.

STATEMENT BY ALBERT B. ELLENTUCK, CHAIRMAN, TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC

Mr. ELLENTUCK. Let me address that first, then I will make my statement. We have a general feeling that the talk about tax revolt and the talk about unfairness compounds with the increasing complexity of the tax law, and perhaps gives the public an impression that the tax law is a lot less fair than it really is. I mean, that is really what we are trying to address.

Senator PACKWOOD. Are you saying that taxes are lower in this country en toto—Federal, State, and local—than they are in most other industrialized countries?

Mr. ELLENTUCK. Well, I think that is true, and I think also the distribution of taxes between taxpayers is important. There is the general impression that the rich get richer and the poor get poorer.

And as CPA's who deal with taxpayers on an ongoing daily basis, we see some of that, but by and large we don't see too much of it. That was really the point we were trying to make.

Senator PACKWOOD. Go right ahead.

Mr. ELLENTUCK. Thank you.

We also applaud this committee for recognizing the need for open debate on the proper direction of tax policy. The AICPA, which has 210,000 members, many of whom devote much of their time to tax practice, strongly favors simplification of the Internal Revenue Code. However, we believe that a number of the sweeping proposals for adopting new tax systems which are being discussed by this committee would, if enacted, heavily impact on the economy. Therefore, we believe a clear and thoughtful debate before any action is taken is essential.

In the paper we submitted, we make several observations about the flat tax proposals which we would like to bring to your attention.

First of all, the argument that a flat tax is needed to reach high-income taxpayers overlooks the presence in the tax law of the alternative minimum tax, which is a broad-based flat tax now superimposed on the progressive rate scale.

Progressivity has been a basic tenet of our tax system. It would be eliminated by the flat tax or greatly diminished by variations of the flat tax under discussion.

The average taxpayer expects that the flat tax would relieve his tax burden. We believe he will be disappointed in that.

We do not believe that at this time, considering the nature of the publicity to date, the public can comprehend the consequences of adopting such a new tax system; nor do we believe that those consequences have been adequately measured. The consequences are potentially so broad and deep for the economy and for individual taxpayers that an indepth study is needed before there will be well-founded, long-lasting consensus for or against change. That's why in the hearings held by the Finance Committee in September of 1982, we recommended the appointment of a National Commission on Tax Simplification, and we reiterate that recommendation today.

Pending issuance of the results of any such study, we also recommend a moratorium on all major tax legislation. Taxpayers and tax professionals must have time to digest the present law and understand what Congress has done in recent years to plug loopholes and curb abuses. Before we can abandon one system for another, we should at least have a full understanding of how the present system is working now that it has been so thoroughly amended in recent years.

The paper we submitted contains a number of recommendations. Considering the time restrictions, I will mention only two:

Even if a moratorium is put into effect, there will nevertheless be some legislation, and we believe that any such legislation should be exposed for comment for a reasonable period of time before submitting it for enactment.

Also, proposed legislation should be given a complexity rating by a competent, impartial panel. for congressmen who wish to promote simplification of the tax law—that rating could serve them as a valuable reference.

We wish to assist in your deliberations, and we hope that the paper we submitted will be a contribution. We thank you for the opportunity of testifying.

[Mr. Ellentuck's written testimony follows:]

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

TAX DIVISION

COMMENTS ON FLAT-RATE INCOME TAX
AND
ALTERNATIVE TAX SYSTEMS

SUBMITTED TO THE
SENATE FINANCE COMMITTEE
FOR THE
WRITTEN RECORD
OF HEARINGS HELD

AUGUST 7 and 9, 1984

INTRODUCTION

The AICPA enthusiastically supports the efforts of the Senate Finance Committee to gather information and opinions on the appropriate direction of tax policy in pursuing the goals of greater equity and simplicity in the tax system. In fact, when the AICPA appeared during the Committee's hearings held on September 28 and 29, 1982, we urged the formation of a National Commission on Tax Simplification to explore the issues and we offered to participate in the effort.

To facilitate our expected participation, the Division established a Task Force on Tax Simplification to assimilate information and draw conclusions which we might share with Congress, the Treasury, our fellow tax professionals and the public.

We certainly agree with the Committee that the taxing system derived from your efforts -- whether an improved version of the current law or wholly new -- should be one which will be supported by a broad consensus. The AICPA wishes to participate in the debate leading to a consensus and submits this paper as a brief summary of our preliminary findings and recommendations. Our views derive from our perspective as professionals who work with the Internal Revenue Code constantly; and as daily, intimate observers of the reactions of literally millions of taxpayers.

PUBLIC PERCEPTIONS AND CONGRESSIONAL REACTION TO THE PRESSURE FOR CHANGE

We appreciate Congress' concern that a segment of the public perceives the present tax law as being harsh, less than fair and not simple enough. To the extent it exists, the reaction, we believe, is traceable to certain identifiable causes:

1. Economic conditions in recent years have been rigorous for many Americans. The individual has been faced with inflation, the buffeting of a series of recessions and "bracket creep"; and despite the tax burdens we all bear the word is out that the federal deficits will necessitate tax increases. It is then no wonder that some taxpayers adopt the attitude that if only "they" would pay their taxes, "our" taxes could be reduced.

2. Public officials, in appeals for budgets for their agencies or in debate on their legislation proposals, speak in pejorative terms of the "tax revolt." Publicity is given to the most extreme statements and some in the press and media echo them as irrefutable truths.

3. Tax legislation then is enacted in response to perceived popular demand for more fairness. But, the economic situation -- for those who had demanded the changes -- is not thereby relieved and the changes are not appreciated since inflation combined with "bracket creep" continues to beset them, and taxes remain high. As a result, before the ink is dry on one tax act, another is being formulated to accomplish the identical

purposes: closing loopholes and curbing shelters. Ironically, the rapidity of the changes in the tax law causes some to be more fatalistic than ever, and louder in their complaint that they do not understand the law. The complexities added in the quest for fairness exacerbate their feelings that others ("they") probably are getting away with all of the tax advantages.

Despite the existence of the foregoing conditions, the AICPA believes that a fair appraisal of them and the public's reaction affords no support for the adoption of extreme solutions. Furthermore, we believe that public education and legislative restraint and change of emphasis will create a far better environment than presently exists.

AICPA members associate with enormous numbers of taxpayers at all levels of income. We gather their tax information and prepare their returns. We are factors in a collection system which is an extraordinary example of honorable self-assessment. We find that many Americans do accept the concept enunciated by Justice Holmes that "taxes are what we pay for civilized society." We believe that many more Americans would feel less imposed upon by taxation if responsible parties included in their public pronouncements that taxes represent a lesser percentage of the United States gross national product than is the case in most other industrialized nations.

We also believe that constant changes of the tax law disconcert all taxpayers. The AICPA recognizes that Congress' discernment of public perceptions is stimulating the ever-increasing number of legislative proposals. Nonetheless, it is also clear that taxpayers will better comprehend and deem more simple the taxes to which they are subject (and would better appreciate Congress' extraordinary recent efforts to make the law more fair) only if there is a moratorium upon change. We acknowledge that it is extremely difficult to say to one's constituents: "Be patient. Give it two or three years, then you will see the effects of the positive changes we just made." But, until this approach is taken, every tax act -- regardless of how painstaking was the effort to plug loopholes, stop abuses, and encourage compliance -- will be a mere prelude to the next piece of legislation which necessarily will be more massive and complex than its predecessor. The AICPA believes that the cycle must be broken.

CONGRESSIONAL CONCERNS ABOUT FAIRNESS

We can also understand Congressional concerns about the common assertion that new laws are merely opening up new shelter opportunities. However, we believe that such concerns are not justified:

1. While we, as tax professionals may differ about details, we can confirm that recent tax acts -- limiting deductions and losses, imposing minimum taxes, penalizing noncompliance, etc. -- have tended to curb the abuses at which they were targeted.

2. Why are taxpayers turning more-and-more to investments in areas of the economy such as real estate, and oil and gas, which traditionally are labelled of a tax shelter character? Why is this true after so much Congressional effort to curb over-indulgence in shelters by imposing penalties and reporting requirements and reducing write-offs? The answer, we believe, is found in pure economic motivation. The routine investment for the majority of Americans used to be the savings account and the stock market. The inflationary spiral of the last 15 years victimized the saver. The average taxpayer became convinced that the best investment he ever made was his house. Why should it be an unpleasant surprise that he, the average taxpayer, now turns to investments purportedly responsive to inflation, and which, incidentally, provide current deductions which relieve "bracket creep", and delay the imposition of taxes until sale.

The flow into such investments does not indicate the failure of Congressional efforts to curb shelters. Abuses have been addressed repeatedly over the last few years by ERISA, TEFRA, and the Tax Reform Act of 1984. All that is now needed is enforcement of the curbs you have provided.

COMMENTS UPON THE NEW PROPOSED SYSTEM GENERICALLY REFERRED TO AS THE "FLAT TAX."

The Present Tax Law Does Embody The Flat Tax Concept

We have referred positively to recent legislation designed to make the tax law more fair. In particular, we should mention the alternative minimum tax. The tax, at a 20 percent rate, falls upon income after adding back a comprehensive list of "preferences." Few deductions are permitted. Accordingly, we find somewhat hollow the contention that the United States must adopt a new broad-based taxing system in order to capture taxes from those failing to pay their fair share, when we as tax professionals know that the targeted alleged miscreants are now obliged to pay the alternative minimum tax. The rate of the AMT is approximately that of the proposed flat taxes. The AMT has been effective; few can escape its net. We realize the public-at-large may not yet be fully cognizant of this fact. But that is not justification for knowledgeable persons to act as if it does not exist.

Progressivity Is Foresaken By The Flat Tax

While the alternative minimum tax is not itself progressive, it serves the purpose of a backstop to what otherwise is a distinctly progressive system.

We know, as tax professionals, that there are vast numbers of taxpayers with high incomes who pay taxes in strict accordance with the progressive rate scales. For them, the flat tax, whether it contains one or several brackets, would be an enormous financial boon.

Flat tax advocates embrace fairness and simplicity as their dual tenets. But, flat taxes generally dispense with progressive rates in the interest of simplicity. Yet, progressivity has been viewed as synonymous with fairness in the American politically-oriented taxing system. Progressivity is a pure reflection of the age-old concept that taxation should be based upon the ability-to-pay. We are astonished that so manifest a benchmark of fairness as taxation by ability-to-pay is being seriously proposed for the scrap heap. We are confounded by the representation that such proposals will be more fair than the present progressive system. Somehow, by obscure rationale, the traditional values are being turned upside-down.

We foresee that, if the progressive rate scale is eliminated from the taxing system, in a year or two, there will be a severe political reaction from the middle-income taxpayer, and an irresistible demand for its reinstatement.

The Flat Tax Will Not Fulfill Expectations of Re-distribution of the Tax Burden

The particular beguilement for the public is the representation that, under the flat tax, taxation will be more fair. Many taxpayers instinctively consider that representation to spell relief, specifically: tax reduction. They believe that "we" will pay less, because "they" will pay more. But, advocates of the flat tax generally acknowledge that their proposals are: (1) revenue neutral; and (2) will not, to any substantial extent, re-distribute the tax burden among lower, middle and high income earners. We have stated above in comments on progressivity that, assertions to the contrary notwithstanding, the flat tax will favor many high income taxpayers. In fact, some proposals openly structure-in an increase of taxes on middle income taxpayers and a reduction for higher income taxpayers. Only a modification of the basic proposals to provide several graduated rates would foreclose this result. But, quite obviously, such modification sacrifices simplicity.

We must conclude that the middle income taxpayer who assumes that he will be a winner from re-distribution of the tax burden is in for a sad disappointment.

A more serious disappointment could be in store for all Americans if the new system is invoked as a stratagem to divert attention from an across-the-board tax increase. The flat tax proposals have the potential to severely impact upon the socio-economic system in the United States, as more fully discussed below. Therefore, it is imperative that the proposals should be considered in great depth purely to determine if their merits outweigh their deficiencies. They should not be pressed into service for any extrinsic political purpose.

The Flat Tax May Not Appreciably Simplify The Tax Law

The AICPA doubts the validity of the contention -- so basic to the appeal of the flat tax -- that the average taxpayer's return will be significantly easier to prepare. Those expenses which now commonly appear on tax returns of most middle income taxpayers would continue to be deductible under prominent flat tax proposals. In addition, the base-broadening process would cause more items, such as various employee fringe benefits which are now excludable, to be reported as taxable income by the average taxpayer.

The problem for Congress, which would accompany the adoption of any entirely new system of taxation, would be to make the transition fair to taxpayers who made long-term commitments in reliance upon past law. We foresee the adoption of a new set of complex rules involving sets of effective dates, carryforwards, elections of alternative treatments, etc.

The Underground Economy Will Not Surface

The AICPA challenges the assertion that passage of the flat tax would cause the underground economy to emerge and face taxation and regulation. To the extent the underground economy is comprised of organized crime activities, the assertion is patently baseless. To the extent the underground economy is made-up of persons who work "off the books" the rates which now would apply to their activities probably are less for most than flat tax rates.

To the extent persons operate underground to escape social security and sales taxes, governmental paperwork and regulation the solution is not the flat tax. The AICPA issued a report entitled, Underreported Taxable Income: The Problem and Possible Solutions, in January, 1983. We believe that adoption of its recommendations would result in contraction of the underground economy; but, we also believe that adoption of the flat tax would have no appreciable positive impact.

The Economy Would Be Profoundly Affected By Adoption of the Flat Tax

Advocates of the flat tax are heard to proclaim that the effect of the tax law upon economic decision making should be neutralized. However, the AICPA believes that the very act of extreme change such as adoption of a flat tax, will severely shock the economy as it is presently constituted. We would view this result as antithetical to the goal of neutralization. We do also believe that, in the absence of adequate study, it is impossible to reliably project the impact of such change upon the economy.

Countless long-term economic commitments by business and by individuals have been predicated upon the assumption of reasonable constancy in the tax law. Virtually every business and investment decision has been (and, we may add, will continue to be) evaluated in advance on the basis of its after-tax results. Even apparently slight changes in the past have shaken the foundations or promoted the growth of major segments of the economy. To illustrate the point:

- Adoption of the Accelerated Cost Recovery System revived real estate construction throughout the country. When Congress recently contemplated extending the recovery period, industry representatives presented evidence to show that many projects would no longer be feasible. Congress responded by modifying the original proposed change.

- Charities, and, of course, the beneficiaries of their good works, depend to a large extent for financing upon the subsidiary granted to contributors, particularly high bracket taxpayers, in the form of the charitable contribution deduction.

- States and municipalities have established tax and expenditure levels with due regard to the deductibility of taxes on the Federal income tax returns of their residents. Furthermore, many states have tax systems which rely upon the Federal measurement of taxable income.

- States and municipalities borrow at advantageous interest rates set by reference to rates earned after-tax on Federal and corporate bonds.

- Millions of Americans decided to buy homes and seek medical care because the interest paid on their mortgages and their doctor bills were tax deductible and thus affordable.

The foregoing are only a few illustrations of the interlocking relationship of economic decisions and the provisions of the tax law. The elimination of credits and lowering of the tax brackets in which deductions and losses will be taken will be profoundly disorienting to the economy. In addition, the value of property typically acquired on credit such as personal residences, industrial plants and equipment, personal autos, etc. is bound to drop precipitously if mortgage interest and financing rates effectively rise because of Federal rate reduction.

The AICPA believes that the millions of taxpayers who would suffer the consequences of a change to a flat tax system, will not embrace the theory that tax effects upon transactions must be peremptorily neutralized.

The AICPA's recommendation of appointment of a National Commission on Tax Simplification postulates that the body would have the resources and intent to bring together authorities to study and report on the economic impact of the various new proposals. We do not believe that the broad consensus for a new tax system, which is sought by the Senate Finance Committee, can be developed in the absence of such a convincing report.

The Ability Of Administrations And Congress To Influence Economic Decisions Through Tax Policy Should Not Be Abdicated

Over recent decades, the economy has faltered at times. Investments in plant and equipment by basic industries fell to critically low levels. The ability of American industry to compete in the international marketplace diminished because of a reduction of research and development expenditures. Unemployment rose. Investment in low income housing became insufficient to meet the demand. In each case, Administrations proposed and Congresses adopted tax incentives to meet the specific problem with salutary effect.

The flat tax proposals, in general, deny future use of tax incentives to stimulate the economy with the often needed precision. The AICPA believes that the flat tax will introduce simplicity at the sacrifice of the flexibility inherent in the present system. The consequences defy current estimation, and we believe this, too, should be the focus of study by the National Commission.

AICPA POSITIONS ON ALTERNATIVE PROPOSALS

The AICPA issued Statement of Tax Policy 2, Value-Added Tax, in 1975. The statement considers in depth whether an indirect tax such as a value-added tax or a retail sales tax should be used to provide for significant increases in federal revenues in lieu of increasing direct taxes (corporate and individual income taxes). It concludes that an indirect tax at the federal level merits serious consideration.

At this time, task forces and committees of the Tax Division of the AICPA are re-studying the questions addressed in Statement of Tax Policy 2, and have undertaken also to consider the advantages and disadvantages of consumption taxes as alternatives, in whole or part, to taxes on income. Conclusions on these matters will be forthcoming shortly.

It is abundantly clear, however, at this juncture, taht a drastic change of the tax system is bound to affect United States citizens living abroady, foreign citizens living in or investing in the United States, and international business activities; and will necessarily disrupt previously negotiated tax treaty relationships.

Other matters of current concern to the Senate Finance Committee have been addressed by the AICPA. For example:

- Statement of Tax Policy 3, Elimination of the Double Tax on Dividends, was issued in 1976. It came out in favor of integration of corporate and individual income taxes. The Division is in the process of re-examining its position, and will submit its conclusions to the Senate Finance Committee as promptly as possible.

- The AICPA published a Study Document entitled, Proposal For Complete Revision of Subchapter S Corporation Provisions, in 1978. Among other things the paper recommended expansion of the opportunities to adopt S Corporation status. The AICPA was pleased that many of its suggestions including the aforementioned were reflected in The Subchapter S Revision Act of 1982. We beleive, however, that the goal of simplification would be further served if Congress amended the Act to permit more corporations to qualify as S Corporations.

THE AICPA'S PROPOSED PROGRAM FOR TAX SIMPLIFICATION

In the introduction to this paper, we referred to the formation by the AICPA's Tax Division of a Task Force on Tax Simplification. Preliminary conclusions have been reached both on the appropriate directions to follow in the legislative quest for simplification, and on actions which can be undertaken to heighten the public's comprehension of the tax system:

- Appoint a National Commission on Tax Simplification this would provide an ideal forum for all organizations and the public to express their views.

- Impose a moratorium on substantial changes of the Internal Revenue Code. Fairness and simplicity tend to be incompatible goals, and Congress' efforts in recent years to make the tax law more fair have piled one complex provision upon another.

- Focus future efforts to simplify the tax law upon the problems faced by individual taxpayers (with special emphasis upon the lower and middle income earners) and those faced by small businesses.

- Consider an increase of the zero bracket to eliminate the complexities associated with itemizing deductions for vast numbers of individual taxpayers.

- Analyze complex Code provisions to determine whether small businesses can be excluded from their application by the infusion of liberal "safe harbor" exclusions.

- Expose proposed tax legislation for a reasonable period of time. Comments should be requested on the compliance problems faced by taxpayers if the provisions were adopted.

- Rate legislative proposals on the degree of complexity they would introduce to the Code. Today, the revenue effects of proposals are set forth; in the future, the "complexity rating" should be given the same prominence.

- Prompt the Internal Revenue Service to intensify the effort to simplify tax forms and instructions. The recent introduction of the popular Form 1040EZ is an example of a positive step which should be followed.

- Provide additional resources to the Internal Revenue Service, to be applied to increasing taxpayer education and assistance in preparing returns.

- Promptly after the passage of new legislation, the Internal Revenue Service should issue to the media clear explanations of those provisions affecting individual taxpayers and small businesses. The explanations should be in readily understandable question and answer form. In determining what questions are likely to be on the minds of taxpayers, the Service should elicit the opinions of tax practitioners.

CONCLUSION AND RECOMMENDATIONS

Our present tax system has developed over a period of 71 years. In its basic elements -- the taxation of income, the availability of common deductions, the progressive rate scale -- it is known by every individual. With reasonable efficiency, it extracts from the economic system the fuel to run the governmental machinery. The economic system itself, to which the taxing system inter-relates, is the most complex pattern of interacting elements known to man -- perhaps only with the exceptions of the human body and the solar system. The innumerable decisions to tax in particular ways were based upon intensive examination of the economic consequences to the parties affected. Countless business, investment and personal decisions have been made in this country based, at least in part, upon the tax consequences.

Proposals to abandon the tax structure and adopt another should be approached with the same degree of caution as proposals to "improve" the human body through genetic engineering, or "improve" Earth's position in the solar system. We do not know the side effects: in the first case, a man might lose the power to speak; in the second, the Earth might hurtle away to oblivion. In the case of radical change of the taxing system, we may see vital industries starved for capital, charities abandoning their good works, foreign countries furious with us, and state governments on the federal dole. We also do not know whether this nation can afford to have future Administrations and Congresses without the power to use tax policies to influence the economy.

If the proposals are implemented, the decision-making processes will begin anew. Thousands of businesses will guess at the pending decisions of millions of individuals. When the inter-relationships will be brought into balance is pure speculation.

The AICPA wishes to offer the following recommendations and assurances:

- We recommend that rather than have action for its own sake, all parties to the debate reflect upon what has been done by Congress in recent years to make the system more fair, if not more simple. We believe that facts should be proclaimed to counter public misapprehensions. The AICPA through its Tax Division would be pleased to participate in the effort.

- The AICPA previously urged the appointment of a National Commission on Tax Simplification to the Senate Finance Committee, as mentioned in the introduction to this paper, and we hereby reiterate that recommendation. We believe that an indispensable ingredient of the Commission's final product should be a report upon the impact of all proposed changes upon the American economy.

- The AICPA through the committees and Task Forces of the Tax Division will continue its study of the present system and the proposals for its revision. The comments contained herein are on the basis of preliminary analyses. We do wish to further clarify what we believe would be the effects of proposed changes upon the economic system. We would be pleased to share our findings with a National Commission on Tax Simplification, and assist in drawing conclusions which would be supported by a broad consensus.

- The AICPA also recommends a moratorium on tax legislation. We strongly advocate simplification, and we have no desire to see more-and-more complex provisions added to the Code. We and the public need to be given the opportunity to digest the law. With comprehension will come a heightened awareness of the abundance of provisions making the law more fair. ERISA the Tax Reform Act of 1976, ERTA, TEFRA, and the Tax Reform Act of 1984 were monumental in scope and detail. Let the rules take hold.

The AICPA urges all responsible parties to actively discuss and promote refinements which will remove large numbers of individuals and small businesses from the Code's more complex provisions. And, then let us all join in revealing to the public that Congress has been responsive to their concerns while avoiding endangering the economic system upon which all taxpayers rely.

Senator PACKWOOD. Mr. Ellentuck, thank you. The reason I asked you to elaborate on that question—one of the best publications I have run across is the one put out by the OECD, comparing tax rates in different countries. And indeed, your statement is right. Of the major industrial countries of the world, of the eight major industrial countries, we are the seventh lowest in terms of taxation—only Japan is lower. And in research that I had the Library of Congress do for me, they said to be careful of the Japanese figure, because they provide through business many of the social services that are provided through governments in other western countries. So if you mean, is it a cost of doing business, it is; it just doesn't count as a tax.

And so even Japan would be close to our level of costs, if you counted those costs as a tax.

Starting with this publication, I had the Library of Congress do a study for me of the incidence of taxation on interest, on capital gains, on dividend income, on wage income, and on consumption in those countries. And what it turns out as a rule of thumb is this: The United States indeed has a relatively low rate of total taxation, but it has among the highest rates of total taxation, on capital and income, and the lowest rate on consumption. And what the other countries, our competitors, have managed to do is to provide a level of taxation that allows them to do whatever they want to do, and they basically are levying the tax on those who receive the benefits. And we are not.

Of course, the last advantage of it is that it is rebatable at export, so that it makes it very difficult for us to compete; whereas, our taxes are not rebatable at export.

Steve.

Senator SYMMS. Thank you very much, Mr. Chairman.

Norm, you mentioned that you thought we ought to introduce a bill which would give us a target to shoot at, whether or not it could be passed, that we were on a consistent pattern for.

And Mr. McIntyre suggested the Hall-Rabushka plan—oh, Mr. Keating did.

Mr. KEATING. Right.

Senator PACKWOOD. Excuse me; I'm sorry. You recommended the Hall-Rabushka, and Fred, you recommended the Bradley-Gephardt. What was your recommendation?

Mr. MCINTYRE. We recommended Bradley-Gephardt approach, as well.

Senator SYMMS. You both did? OK.

Norm, are you telling me that what you would like to have seen happen was that when we passed the 1981 Recovery Act, that then after say 3 or 4 years, after that was passed, then work on spending, then come back and just start reducing those rates from where the top rates are now in the same progressive tax code we now have, just continue to reduce the rates?

Mr. TURE. A little more than that, Senator. We also were——

Senator SYMMS. I am going to get up and run off on you, but I wanted to hear your answer.

Mr. TURE. We were also very much interested in revising the tax base. The notion was that ERTA was to be conceived of as a first—but very major—step toward a tax system which would meet the kind of criteria suggested; just a step, an important one, though, to set the momentum, the thrust going, in the hope that we could continue to make changes both in the base and in the rate structure.

Senator SYMMS. Just gradually work toward this instead of making a big massive sweep.

What is your attitude about the Hall-Rabushka tax plan?

Mr. TURE. It is a kind of uniform consumption tax. Its difficulty is that it's a blend, an unnecessarily complicated blend in my judgment, of the value-added tax approach and the so-called consumed-income or cash-flow approach. I think those complications are not needed. I am not quite sure why the authors chose to go that particular route.

One of the things that is terribly important for all of to consider if we go in the kind of direction that I have suggested, is that we do not want to lose taxpayer consciousness.

I think there is a great deal to be said in favor of the annual tax return, if not a more frequent one, on the part of taxpayers so they are abundantly aware of what they are contributing to the Federal revenues.

Senator SYMMA. I thank you very much. I am sorry to run off, but I have to run over and vote.

The CHAIRMAN. You'll get credit for three on one vote.

Senator SYMMS. Well, I'd better hurry, then. [Laughter.]

The CHAIRMAN. What we have is a vote going on, as you probably all know, and that's why I had to leave. I think the others will be coming back.

I missed Mr. Ellentuck. I'm sorry I didn't introduce you earlier. And I missed part of the other statement.

Could I ask, for the record, is there general agreement about indexing? Maybe we will just go down the list, starting with Fred. Does anybody here suggest that be repealed?

Mr. WERTHEIMER. We are looking at all aspects of this point, so we are not prepared to take a position on indexing. We are looking at all of the various questions now on the table.

The CHAIRMAN. Mr. McIntyre?

Mr. MCINTYRE. Well, unfortunately I have trouble giving you an opinion, too, because the members of my coalition are split on it.

The CHAIRMAN. Good. [Laughter.]

Mr. Keating.

Mr. KEATING. Well, I think you know my position by now. I think indexing is essential to any major tax reform bill, especially if we keep graduated rates. Otherwise, we will have the same problem that Senator Long talked about earlier: creating new loopholes and exemptions, and things like that.

One of the reasons Congress has been able to create new tax loopholes in the last 15 years is because there was an inflation bonus from the income tax. I think indexing is one way of keeping Congress on the track.

The CHAIRMAN. Norm.

Mr. TURE. I am sure you are aware of my views, Senator. I think indexing was one of the most constructive advances that was made in ERTA, and I am terribly concerned about seeing it always on the front of the firing line since then. I do hope it can retreat to a comfortable position and viewed as a permanent forever-more part of our tax system.

The CHAIRMAN. Mr. Ellentuck? Do you have a recommendation, or do you have any ideas on indexing?

Mr. ELLENTUCK. Yes, Senator Dole. We were in favor of indexing when it was passed. We think it would be a step backward if it were repealed.

The CHAIRMAN. I guess on page 9 you made the point that a flat tax may not simplify the average person's return preparation. Couldn't we reduce the burden of the return preparation by raising the zero-bracket amount and the personal exemptions so a higher percentage of taxpayers don't have to itemize their deductions?

Mr. ELLENTUCK. Yes. At present, and I don't have the exact number, a large number of taxpayers do not have a complex tax situation. If you raise the zero bracket, depending on what level you raise it to, you would eliminate complexity for the large majority of taxpayers.

The CHAIRMAN. But I think there is a danger then. If you had a contest around here on how many people we could exclude from income tax, you would have a majority of people not paying taxes who would demand maybe more government, which means the others who were paying tax would end up paying more tax. It may not ever happen, but it seems to me it makes some common sense. I think we have a danger there that we had better be alert to.

Mr. ELLENTUCK. It's a delicate balance. But in a sense you are not eliminating taxpayers from the tax base; you are essentially putting on them what we used to think as the old standard deduction.

The CHAIRMAN. Right. No, I think that has been suggested by other witnesses, that if we are looking for simplification we don't have to get into all these fair, fast, self, whatever. There are other ways it can be done.

Mr. TURE. Mr. Chairman, I think you have just made a very telling point, and if I may I would like to take a moment to emphasize it.

Particularly when there is a pressure for increasing aggregate tax taken, it becomes all the more meaningful that the route toward that is not to say to some substantial part of the population: You're out of the action. The contrary should be true. The more intense the pressure for additional revenue, the more everybody ought to be required to face that decision.

So I think going to the route of very substantial increases in personal exemptions or zero rate brackets has a very serious impediment attached to it.

Mr. WERTHEIMER. If I could also add, Mr. Chairman, the more you are required to face the question of additional revenues, the more also you are faced with the fairness issue, as well as simplification. And then it takes you——

The CHAIRMAN. I think that's correct. And I think generally—I am certain there are some exceptions where people say, "Well, you should have done this." We have tried to address the fairness issue in 1982 and again in 1984. President Reagan gets a lot of criticism, but he did support a couple of tax bills that are loaded with loophole closers. I am certain that maybe Norman and others didn't agree with all of those things we did, but they were an enormous effort to broaden the base and for the most part I think constructive.

I recall when we were trying to get up to $48 billion, we got stuck on $42 billion. And we asked the Treasury to send up some more loopholes, and they said, "We're out of loopholes." You know, maybe for just one day. [Laughter.]

Mr. **Wertheimer**. It was a short period, Senator.

The **Chairman**. Right, not a permanent shortage. I guess that was the guy-in-charge-of-loophole's day off. [Laughter.]

But we have made an effort, and I think sometimes when we talk about all of this—and I know it's the political season and I shouldn't even bring it up, "but we know the President supports the rich," and all these things—but I must say I think the record will reflect, if not during the President's second term then after he leaves, that he did help us make some difficult choices.

Mr. **Wertheimer**. Mr. Chairman, in your absence I did take note of that progress, and we supported those efforts in 1982, and it has been progress. Frankly, we think it's the right track, except we feel there is a broader, wider road to go, and we have to go it.

The **Chairman**. There is no doubt in my mind that there are still a lot of nuggets lying around in the code there that haven't been dusted off for a long time.

I would think with all these people advocating flat taxes, at least they would help us modify some of those. I mean, they outright repeal all of these incentives, depending on your point of view.

But it is going to be very difficult, because there is a big political debate going on right now about taxes or no taxes, and my view is, which I have tried to express, you know, we admit that Walter Mondale should get the first blue ribbon on raising taxes—he really believes in it. It is a priority with him, and it's a last resort with President Reagan.

But in the meantime, just as one Republican, I think it would be a mistake just to lock up that area and say, "Under no conditions will there ever be any tax changes," because then you put the pressure on the President to start telling us where he is going to cut spending to do all of these things. And if you are not going to cut defense, you are not left with too many options. My own view is that some of the President's friends may torpedo him yet. I hope not.

How would you address that if you were going to write the platform, Norm? You've been around for a while. Or would you just skip the platform? [Laughter.]

Mr. **Ture**. I'd like to have a hand in that drafting, indeed.

The **Chairman**. It would have to be artfully drawn, I think, for everybody to be satisfied.

Mr. **Ture**. No, I would agree wholeheartedly, Mr. Chairman, that the notion that we are once and for all done with tax policy is fatuous. There is a huge amount to be done in reforming our tax structure. I'm not sure that you and I would necessarily agree about the specifics of that. I would like to go to a system that is indeed a lot simpler, that is a lot more nearly uniform. I think we probably agree that it is not practicable to think about getting there in one single leap, but I'm concerned about the fact that we deviate from a path with undue frequency.

I am also concerned about the fact that we don't probably identify objectives as clearly as we might, and we do use an awful lot of phrases that I think turn out to be pretty empty when you examine them carefully.

I wouldn't mind at all, to take up the second point that you raised, having the President under some considerable pressure to identify what he wants to do on the spending side of the budget. I disassociate myself from some of my conservative friends in that I don't think the problem is flatly just too much Government spending. I think the problem really is the way in which we determine what the Government does, why it does it, how it does it, and then ultimately how much it does. I think it would be delightful to see a reformation of the system with which those questions are addressed at both the administrative and the congressional level. I would be much more content than I am today with the results of spending decisions if they were made that way.

Right now it seems to me that most of the congressional committees are captured by what happened last year. What happened last year is an event, but it isn't necessarily the best guide for the future, and I would like to see a good deal more freedom in the Congress in making decisions about where we want the Federal Government to go, why we want it to go there, and how to get there in the best way. If that calls for a substantially larger government than we now have, I don't think it would, but I think under those circumstances the body politic would have to look at that and say amen.

This inveighing against the fact that our public sector is too large a fraction of GNP it seems to me doesn't mean a bloody thing. I don't know what significance one is supposed to attach to Federal outlays being 24-whatever it is percent of GNP. I just don't know how to interpret that, and I never have been able, and I couldn't tell anybody else what to do with that. If it says "lower," I'd like to know lower in what way? I don't want much of that "lower" to come out of the defense budget, to take a simple case in point.

The CHAIRMAN. Well, I think that's the dilemma we face. And of course there is the broader question, whether the Congress has the will as an institution—not the Democrats or the Republicans, but whether we have lost that, if we have ever had it, but if we have lost it to make the hard choices around here. It is easy to make the easy choices, to vote against any tax increase, to vote for tax cuts, and then to vote not to cut spending. Boy, that's a ticket for reelection if there ever was one. It's also a ticket for high interest rates and big deficits. I find some of my conservative friends in the House who use us as the whipping boys in the Senate, and I look at their records, and I'm appalled to see all the things they vote for, and then they criticize us for changing the tax structure.

So it is difficult. And there is this high-powered group looking at Congress, seeing whether we ought to be restructured, or abolished, or whatever. And I think it is a fairly close question. [Laughter.]

Senator Bradley, they are all against your proposal.

Senator **Bradley**. Thank you, Mr. Chairman. I see you are practicing your convention speech here. [Laughter.]

The **Chairman**. Well, I only have 5 minutes. I'm trying to give it to my wife so she'll have 10. [Laughter.]

Senator **Bradley**. Let me ask just a few questions.

First, to Mr. McIntyre—I appreciate very much your words of support for our effort, and I'm curious to ask you: Do you sense anything out there in the public that makes you believe that this kind of tax reform is any more possible now than it's ever been?

Mr. **McIntyre**. Well, we do. We have member groups around the country, and in the last year and a half, basically since your proposal was put forward, they have started coming to us telling us they want to organize at the local level. They want to make tax reform a major issue for them, because we have come to the end of the road on trying to make this Government do its job any better, until we figure out a way to raise the money to do it.

It's also an issue for them, by the way—and Congress ought to be aware of this—at the State level. If something like Senator Bradley's proposal for example, was adopted tomorrow, State tax revenues from personal and corporate income tax would go up by as much as two-thirds or more. Of course, the State governments wouldn't keep all or most of the money; they would cut the tax rates. But it would give them the opportunity at the same time to look at their priorities. So it is an important issue around the country right now. People see it, they saw what happened in 1981 when the tax base was narrowed and the States were in trouble, and now they are saying, "Well, if they broaden it, maybe we'll have a chance to do something better."

Mr. **Ture**. Senator, can I address that question?

Senator **Bradley**. I would like to just go down the witnesses and when we come to you, you can. I would like to ask each person. I have a number of questions for you, Mr. Ture.

Mr. Keating, you say one of the criteria that you think we should have for tax reform is that it be revenue neutral. Does it trouble you that the letter that the Joint Tax Committee sent to Senator Dole just a few days ago showed the Kemp-Kasten increasing the deficit dramatically over time?

Mr. **Keating**. No, it didn't, because I think those estimates are very tentative, as the committee staff director indicated.

I think the Kemp-Kasten bill is well within the range of error of the capability of the joint committee to estimate revenue neutrality.

Senator **Bradley**. All right.

Mr. Wertheimer, I would like your assessment as to why you think the FAIR tax is the fairest of the taxes that we are dealing with.

Mr. **Wertheimer**. Well, because I think we believe it combines a series of principles that we are looking at.

Senator **Bradley**. And Common Cause is in basic agreement with the principles?

Mr. **Wertheimer**. The general approach. As I have noted, that does not mean we endorse all of the specifics. We are concerned about base broadening; we are concerned about progressivity; we are concerned about minimizing the number of preferences in the system. It is those factors.

I would just like to add, it's that combination that attracts us to your proposal as a framework for fighting out what would be one of the more extraordinary battles in Congress that anyone has ever seen.

But going back to your earlier question—why now?—I think there are a combination of factors. I think education and knowledge and the public being convinced about the unfairness of the present system; I think the public is starting to learn more and more that there is a price for all of these preferences that go into the act. I think the knowledge or the sense of that is relatively new. I think part of that comes out of the bills that were passed in 1982 and 1984. I mean, those bills are educators.

Finally, I think you are going to be faced with some extraordinary budget questions in 1985. It is going to be a unique situation.

Senator **Bradley**. Thank you.

Mr. Ture, in your proposal you say that you would like to get the deficits down, if possible to exempt savings from tax and you would like the rates of tax to be very low. If you knock out the taxing of savings and investment and indeed get low rates of tax, aren't you left with a sizable gap and therefore a bigger deficit?

Mr. **Ture**. Let me correct one of the premises, Senator. I did not address the question of the deficit; I think my view of the deficit is not the important fiscal variable for the Congress to be concerned with are well known.

The question as to whether or not the kind of tax I am talking about would produce as much revenue as that which we now have, it cannot be answered in any categorical way, because it really depends upon how you would design both the rate structure and the personal exemption, the zero-rate bracket, and whether or not you would provide any substantial exclusions from the tax base which I have described.

If you took that base to its logical conclusion, it would include all current consumption, and it would be an extraordinarily large base indeed, much larger than the present income tax base, and you could put a very substantial zero rate bracket and personal exemption together with that to provide some fairly brisk progressivity of tax liabilities, effective rates, which I think is where the action ought to be, if anyplace, and do so with a relatively low single rate of perhaps somewhere between 20 and 25 percent. But there are too many variables for me to give you a single answer.

Senator **Bradley**. Would you also think in the proposal you have made that you would need to look at estate and gift tax rates?

Mr. **Ture**. In that proposal there would be no separate estate and gift tax.

Senator **Bradley**. There would be none?

Mr. **Ture**. No. What would happen is that the beneficiaries of any such transfer would take the amount of the property into their income base. To the extent that they retained it in invested form, then they would be allowed a deduction of exclusion of it. To the extent they used it for consumption purposes, it would go into the tax base directly.

Senator **Bradley**. But at the death of the owner, you wouldn't have any estate tax at all?

Mr. **Ture**. No. Indeed not.

Senator **Bradley**. So under your proposal, essentially, wealth would be transferred from generation to generation without any tax?

Mr. **Ture**. Insofar as it was retained in productive use rather than being allocated for consumption use.

Senator **Bradley**. All right.

Let me ask you, because you have done so much work on this: You tend to look at the economy as—I think you used the term "static." But it changes over time.

Mr. **Ture**. Oh, I would never describe the economy as "static."

Senator **Bradley**. Well, let's say you look at the economy and the tax rate structure as a snapshot, then, and you didn't describe it that way—I did.

The question is, If you lower tax rates substantially from your analysis is there any evidence that would show that the low rate would indeed stimulate greater activity over time, and therefore more after tax dollars for the individual who exerted that greater effort?

Let's say, for example, that you had a rate of 14 percent on an income of $20,000. And let's assume that that person could earn another $10,000 and still pay no more than 14 percent. Now, do you have evidence to show that that is a real incentive? And indeed that that happens, once people know that the marginal rate has dropped considerably.

Mr. **Ture**. Other things being equal, Senator, I think that would be a marvelously constructive thing to do. Of course, I place a great deal of weight on other things being equal.

The evidence is very difficult to assemble, by virtue of the fact that the economy is not static. No economy that I know of is, and there are a great many variables that have to be pulled out in order to be able to identify the affect of this one sort of move.

But let me put it this way—you would have to assume very peculiar kinds of human beings, human beings which I hope do not represent our population, to assume that with that kind of a change—and, again, with the other things being equal—that the response would be either inconsequential or counterproductive.

Senator **Bradley**. So that, indeed, if you reduce marginal tax rates you are arguing common sense would indicate you would get a greater effort, greater savings, or more work from the people?

Mr. **Ture**. Indeed.

Senator **Bradley**. Thank you very much.

Just one other thing—you did say something that I just heard, and I just need a confirmation.

You said a pure flat tax is biased against savings and investment. I didn't understand that.

Mr. **Ture**. A pure flat tax—of course, everybody's notion of what a pure flat tax is may very well differ—I would take as an appropriate reference a description thereof in the Treasury Department's "Blueprints for Basic Tax Reform" published in 1977, the first option. That is a tax base in which there is virtually zero by way of exclusion. All gross earnings save only the cost of producing the income would be included in the tax base.

One of the requisites of that kind of a tax system is, all current saving is taxed, and all the returns on that saving are taxed as well. There is a very simple arithmetic demonstration of the fact that what that does is to raise the cost of saving relative to the cost of current consumption uses of current income.

Again, you can assume that people are indifferent to that, but you can do that by assuming they are very peculiar people indeed, which I'd rather not do.

Senator BRADLEY. Just one last question, if I could, Mr. Chairman.

I have read your testimony and I know what you advocate. Let's assume that the committee doesn't move in the direction of a consumption-based tax, as you have advocated. Is it your view that it would be positive for the economy if we headed in the direction of not just closing loopholes but using the revenues derived from closing the loopholes to lower the tax rates?

Mr. TURE. I think it's essential. I would put two fundamental criterion in place. You want the most nearly uniform tax base, excluding the broadest amount of all kinds of savings and investment current that you possibly can, and you want the lowest and flattest rate structure you can possibly achieve.

Senator BRADLEY. Thank you.

May I add the comment that I wanted to offer before, Senator? You had asked about whether or not this appears to be a time for the kind of thing that you suggested.

First of all, I would like to offer gratuitously a commendation to you, because so far as I know it was your effort last year which really triggered the similar efforts by many of your colleagues in both chambers—Senator Roth, for example. And even though I disagree with the specifics of your proposal in many respects, it seems to me that was an enormously salutary development. And I think you deserve great credit for going out front with that, along with Congressman Gephardt.

Second, I hope that you are struck, as I am, by the fact that so many of your colleagues in both Chambers have come forward with their own proposals for sweeping restructuring of our present tax structure. It may very well be that some of you can recall when this has happened in the past, but at least in the postwar era I cannot recall anything like this. And I muse about the prospect of those of you who have delivered into the hoppers of such proposals and addressed your constituents on these things, retreating from them toward the kind of much more particularistic and specialized tax legislation that we have had over most of our postwar period. I think you are going to be hard pressed to lose that momentum. I think this is a very exciting time in tax policy.

Senator BRADLEY. Well, let me thank you very much for your comments. I agree with you that it will be hard to retreat, and I think the atmosphere for this was created not only by the 1981 Tax Act but the 1982 act as well, and Senator Dole is the major mover of that, because it framed the issue of lower rates and fewer loopholes in a very real way for people, and I would hope that we would continue to move forward, too. I think Senator Dole's leadership here is essential. [Laughter.]

The CHAIRMAN. He can't lose with this operation.

Well, we appreciate that, and we'll keep that in the record—that last part. [Laughter.]

Senator BRADLEY. I was just trying to balance it out, Mr. Chairman.

The CHAIRMAN. Right.

No, there has been no doubt about it, there has been a lot of discussion. The hearing part is the easiest; the markup part is something else. And I would guess that if we started marking up any of these bills, say in September—we talk about the long line of Gucci's outside this corridor; I don't think this building could contain all of the lobbyists who would show up for the markup if you moved to any of these. And maybe that's good. We like to have people visit the Capitol. [Laughter.]

So it is going to be a very interesting exercise. I think the President will have the Treasury report December 1 on all of those proposals. They have had some hearings around the country. I think it's timely that they are going to report in December rather than earlier, but that is probably a strategy that I don't understand.

So we will be working with all of you again, because I know there are different views. We are just trying to make the record now, so that during this next few weeks the staff and others can look at some of the statements in more detail, and we will have a couple of more days of hearings in September and then hopefully really get into serious business. You know, let's face it: It's very easy to have a hearing where there is no pressure at all on us, but the hard part will come if in fact there is the momentum—as you said, Mr. Ture—to really do something. And if it's going to be a radical change, it's going to be tough to do.

Well, we appreciate it. Does anybody else have anything?

Mr. TURE. I would just add, Mr. Chairman, that we at IRET are going to try to help you by holding a conference on the 18th and 19th of September at which the authors of many of these proposals will be asked to make presentations. Senator Bradley has agreed to do that, and we are looking forward to hearing him.

Mr. ELLENTUCK. I did want to say, Senator, that we see the present complexity of the tax law as being driven by Congress' efforts to make the law fairer and close all of those loopholes.

Speaking as somone who is dealing with taxpayers and trying to understand the law ourselves and explain it to our clients, we would really love to see, as this debate on alternative tax systems takes place, we would love to see some concentration on simplification and even the moratorium, which I mentioned in my remarks, to let this law settle in, to let us understand it and to let the taxpayers understand it.

The CHAIRMAN. That creates a problem, because we have all of these pressures to do things, plus there are revenue pressures, at least according to some. And when you make those changes, no doubt about it, we end up with a 1,300-page bill that must create some problems for those who have to deal with it on a daily basis.

And we are already working on technical corrections to the last act. Plus, other people have already suggested we have gone too far. So, we would like to avoid taking up a tax bill every year—at least, I would. One way to do it is to move from this committee into some other job. [Laughter.]

But in any event, we now have the final panel.

Thank you very much.

Paul, you are the vice president, taxation and fiscal policy department of the National Association of Manufacturers. Frederic Howard, chairman, Tax Task Force, Coalition of Service Industries; Dirk VanDongen, chairman of the Coalition To Reduce High Effective Tax Rates; David Mitchell, president, Smaller Manufacturers Council; Nicholas Calio, vice president, government relations, National Association of Wholesaler-Distributors.

I think Mr. VanDongen's was covered by Mr. Albertine.

Mr. CALIO. That's correct, Mr. Chairman. Mr. VanDongen's testimony was covered by Mr. Albertine.

The CHAIRMAN. All right. We will start with Mr. Huard.

STATEMENT BY PAUL HUARD, VICE PRESIDENT, TAXATION AND FISCAL POLICY DEPARTMENT, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, DC

Mr. HUARD. Thank you, Mr. Chairman. In view of the time here and the fact that a lot of us didn't bring our sandwiches, I will try to summarize my summary.

The CHAIRMAN. We apologize. We never know where the last panel is going to come, but we know it is going to be late. It is not that we aren't as much interested, and we are trying to make a record. If you could summarize, it would be helpful.

Mr. HUARD. Again, I think like all the other witnesses, we would probably agree on two things: First, that we applaud the committee for this effort. We think it is needed. The system is excessively complex. Compliance is not what it should be.

We think the bottom line right now is—sort of taking my lead from an editorial I read in the Washington Post several days ago, where they said, "What we probably need over the short term is not the best tax system that you could conceive of, but the best tax system that you can enact." And the clause following that was, "and that may well be something like a national sales tax."

I suppose I should get nervous, since this is the first time in 15 years I have agreed with the tax policy of the Washington Post, but that's essentially the conclusion we come to. We get there for several reasons:

One, while we do agree with the administration that the primary focus on deficit reduction should be to exhaust all possible spending cuts first before turning to revenue increases, we have to be politically realistic. I think the history of the 1984 act suggests that it may very well be unlikely that you can get meaningful spending reduction unless it is packaged with revenue increases, political compromise being what it is.

That leads us to the conclusion that none of the reform proposals are really viable, whether it is the fast tax, the fair tax, the simpliform tax, the 10-percent pure flat tax—all of these proposals do the same thing in different ways; they repeal 30, 40, 50, 60, 70 different preferences, credits, and exclusions now in the code. And as you point out, you would have a lot of people visiting the Capitol. And I think if any of those proposals can be enacted at all, it's probably over a long period of time.

And I think the pressures for deficit reduction or revenue are such that you have to consider something in the nature of a so-called, shall we say, "quick and dirty" approach.

And there you really only have two choices: You can have a surtax, which we tend to agree with you is an abominable tax that magnifies existing inequities; or you can have a so-called add-on which leaves the existing system imperfect and, bad as it may be, relatively undisturbed for the short-term future, and handles the perceived need for additional revenues. In that regard, we think some kind of transaction based consumption tax would be the most viable approach.

A tax of that nature would have a number of advantages.

The CHAIRMAN. What kind?

Mr. HUARD. A transaction-based consumption tax, in the nature of either a value-added tax or a retail national sales tax. They are essentially equivalent. The point of collection issue is essentially the difference.

You have a valuable stimulus to exports, because those taxes are rebatable, whereas the producer cost of our current manufactured goods, which has a high incidence of payroll tax and income tax in it, is not rebatable.

You would have a very wholesome shift from the present state, where we collect 90 percent of our revenues from income and payroll taxes and less than 10 percent from consumption taxes, more to the European distribution. And we think it is a solution well worth considering, in lieu of these very ambitious and we think nonviable reform proposals.

Thank you.

The CHAIRMAN. Mr. Mitchell.

[Mr. Huard's written testimony follows:]

STATEMENT OF
PAUL R. HUARD
ON BEHALF OF THE
NATIONAL ASSOCIATION OF MANUFACTURERS
PRESENTED AT THE HEARINGS ON TAX REFORM
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
AUGUST 9, 1984

I am Paul Huard, Vice President for Taxation and Fiscal Policy of the National Association of Manufacturers (NAM). NAM is a voluntary business association of over 13,500 companies, large and small, located in every state. Members range in size from the very large to over 9,000 small manufacturing firms, each with an employee base of less than 500. NAM member companies employ 85 percent of all workers in manufacturing and produce over 80 percent of the nation's manufacturered goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council. On behalf of our members, I am pleased to be here today to present the Association's views on the subject of tax reform.

Discussion of Present System

Let me state at the outset that we applaud this effort by the Committee to review the manner in which the nation raises its revenues. In our view, the present tax system is both excessively complex and widely perceived as being unfair, a situation which undoubtedly has an adverse effect on compliance. More significant, however, is the excessive reliance of the current system on the taxation of individual and corporate income. At present, about 55 percent of the government's receipts are derived from income taxes. NAM believes this percentage is much too high.

For decades, federal tax laws have tended to favor consumption at the expense of savings and investment. This is evident from the fact that income is taxed when it is earned, and then if it is saved the income on such income is also taxed. Another glaring example of the system's anti-investment bias is the double taxation of corporate earnings paid out as dividends. In such cases, the combined income taxes paid by the company and its shareholders on the company's earnings can rise to as much as 73 percent at the federal level alone.

We acknowledge that the tax system's tilt towards rewarding consumption at the expense of savings and investment was in part redressed by the capital formation incentives contained in the President's Economic Recovery Tax Act of 1981 (ERTA). However, we must also note regretfully that these incentives have already been substantially diluted as a result of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and, to a somewhat lesser extent, by the Tax Reform Act of 1984. NAM believes it is critical that we preserve important capital formation provisions such as the Accelerated Cost Recovery System (ACRS) and the Investment Tax Credit (ITC) without further erosion. These incentives—which should receive a large share of the credit for the strength of the current economic recovery--are necessary to enable our members to increase their productivity and improve their international competitiveness, two factors which are essential for sustained economic growth and greater employment.

Indeed, a major drawback of the present tax system is its adverse effect upon our export competitiveness. Payroll taxes together with income taxes now account for over 90% of all federal budget receipts. A substantial portion of such taxes are reflected in the cost of U.S.-manufactured goods. Under the General Agreement on Tariffs and Trade (GATT), however, it is not possible to rebate, on items exported from the U.S., that portion of an item's cost that can be attributed to the income and payroll taxes paid by its manufacturer. On the other hand, many of our trading partners derive a much higher proportion of overall tax revenues than we do from transaction-based taxes such as the value-added tax (VAT) which, under the GATT, may be rebated on exports. The availability of such tax rebates to exporters in those countries puts U.S. exporters at a significant competitive disadvantage.

At present, the United States government derives well under 10 percent of its total budget receipts from transaction-based taxes that are rebatable on exports. We suggest that a substantial increase in this percentage would be warranted--in general for the purpose of improving the balance of a system that now rewards consumption and penalizes investment, and in particular to improve the export competitiveness of our manufacturing industries.

Tax Reform Alternatives and Timetable

It appears that most of the reform proposals which have surfaced to date are intended to be revenue neutral, meaning they would raise approximately the same amount of tax revenue as the present system. We do not, however, believe revenue neutrality to be a likely characteristic of any major tax legislation that emerges from the next session of Congress. Rather, we think it quite probable that Congressional concern over the effects of large federal budget deficits will lead to further attempts to increase tax revenues.

NAM believes quite strongly that the primary strategy for lowering deficits must be across-the-board reductions in the growth rate of federal spending. A one-year freeze of federal expenditures at current levels should be considered. In the area of entitlements, no new programs should be created and the growth of existing indexed entitlement programs, including Social Security and government pensions, must be curtailed by reducing the indexing formula to substantially less than the increase in the consumer price index. Cost savings, for example those recommended by the Grace Commission, should be implemented at every available opportunity. It is essential that major savings be achieved even in the defense area. Finally, a solution to the difficult Medicare situation must soon be found and must rely principally on cost containment rather than on payroll tax increases.

Nevertheless, we must also be politically realistic. The protracted legislative struggle leading up to the recently-enacted Deficit Reduction Act of 1984 clearly suggests that meaningful spending cuts may be forthcoming only if packaged with further tax increases. We therefore have concluded, albeit regretfully, that the prudent course is to consider tax reform in the context of an attempt to increase federal revenues. In this regard, we think the following approaches are likely to be considered:

A. "Reform" of the system through numerous adjustments to the existing basic framework. This approach would merely repeat the technique used so successfully in TEFRA and the Tax Reform Act of 1984, where literally hundreds of changes modifying existing law were adopted.

B. Major overhaul of the existing tax system, involving a substantial broadening of the taxable income base together with a lowering of marginal tax rates. The base broadening could be achieved by either eliminating many existing deductions and credits, or expanding the definition of gross income to include items presently excluded, or both.

C. Enactment of a tax which is an "add-on" to the existing system and thus leaves that system intact. Surtaxes levied on the present income tax would be one approach; another would be imposition of a totally new tax such as a VAT or a national retail sales tax.

The first approach listed is clearly the least desirable. Legislation such as TEFRA and the 1984 Tax Reform Act merely add further complications to a statute already overburdened with complexity. They are not based upon any discernible principles of sound tax policy. Rather, their primary motivation--and in our view quite possibly their sole justification--is purely and simply the raising of revenue to reduce deficits. At their best, such bills are patchwork repair jobs; at their worst, they are near-classic examples of political expediency. More significantly, we may now have reached the stage where the "tinkering" approach has been so overused that it will produce only diminishing returns.

Attempting a major overhaul of the existing system does have a great deal of appeal, particularly from the standpoint of simplicity. Any such overhaul, however, is likely to face enormous obstacles. In particular, efforts to broaden the taxable income base can be expected to give rise to substantial resistance on numerous fronts. All of the comprehensive base-broadening plans we have examined would require repeal of literally scores of exclusions, deductions and credits presently in the law. Each such provision was adopted for policy reasons considered meritorious by the Congress and many of these have been in the law for decades. Most such provisions have constituencies that can be expected to react vigorously in opposition to the proposed repeal. In some cases, for example with regard to capital formation incentives such as ACRS and the ITC, NAM would be in the forefront of those resisting repeal.

Another problem is that wholesale repeal of existing law provisions is bound to be highly disruptive in that it will upset the financial assumptions underlying the long-term business and investment planning that goes on every day. Avoiding such disruption would at a minimum seem to require a relatively long transitional period for the phasing in of the new system. Finally, there is the issue of the length of time that would be required to achieve a massive restructuring of the current income tax law. We think it probable that some in Congress may want to increase tax revenues as part of the next Congressional budgeting cycle. If so, there obviously might not be enough time for adequate consideration of any major overhaul proposal.

In light of the foregoing considerations, the final generic approach that we mentioned--an "add-on" to the existing system--seems to have some promising features. An "add-on" tax that is simple and fair could be enacted in a much shorter time frame and with considerably less attendant controversy than could any major overhaul or restructuring proposal. Of the two "add-on" proposals most often mentioned--income tax surtaxes and transaction-based consumption taxes--it is clear that the latter are much to be preferred to the former.

Income tax surtaxes are simple, but they are hardly fair. Indeed, they would only serve to magnify existing differences amongst taxpayers, so that those already paying the highest effective rates would also pay relatively more in surtaxes. Moreover, such surtaxes would further exacerbate the already excessive reliance of the U.S. government on income taxation as the principal source of its revenues. For these reasons, NAM would strongly oppose the imposition of surtaxes on the existing income tax.

The various factors recited above, among others, have led NAM to conclude that a consumption-based tax would offer the best balance between the need to retain incentives for savings and investment and any perceived need for additional federal revenues. Revenues from such a tax could be used at least in part to replace revenues from the existing income tax system, thereby reducing its bias against savings and investment. Any revenues not so used should be applied exclusively to deficit reduction.

On this last point, we share the concern, expressed by many others, that consumption taxes are such powerful devices for raising revenue that their use might serve to fuel a resurgence in Congressional spending. We therefore would enthusiastically support statutory or constitutional limitations intended to preclude such a result. The possibilities include--but are not limited to--a balanced budget requirement, a limitation on spending as a percentage of the gross national product (GNP), a limitation on growth in tax revenues geared to GNP growth, or a dedication of all or a specified portion of the revenues from the new tax to deficit reduction.

Design of a Consumption-Based Tax

NAM believes that a consumption-based tax should include the following design features:

Simplicity. The tax should be simple to understand and to administer. This factor clearly points to a transaction-based consumption tax, *e.g.*, one imposed on an *ad valorem* basis when a taxable product or service changes hands. Indirect approaches to taxing consumption, for instance the so-called "consumed income" or "cash flow expenditure" types of taxes which, in effect, provide unlimited deductions for net savings and investment, are theoretically quite attractive. However, they would lead to an unprecedented increase in the recordkeeping required of individual taxpayers. Determining what is a deductible addition to savings and investment would raise many difficult definitional problems. (For example, is purchase of a personal residence consumption or investment?) Fairness clearly would appear to mandate extensive transitional rules for the treatment of amounts put into savings under existing law. Finally, the perception that only the wealthy can afford to save or invest would give rise to substantial political liabilities. Thus, while such indirect approaches would provide a desirable stimulus to capital formation, their practicality is extremely doubtful.

Breadth. Obviously, the broader the base of the tax, the lower the rate that will be required to raise a specified amount of revenue. This is perhaps the most critical factor to be evaluated in determining the scope of any transaction-based tax. We believe the fairest and least disruptive approach is to use the lowest possible rate on the broadest possible base. What this means, of course, is inclusion of services as taxable items and taxation on the basis of full value (i.e., including retail markup in the tax base). If the service sector is substantially omitted, the burden of the tax will tend to fall entirely on manufactured goods and a much higher rate will be required. A similar result will occur if the retail markup is omitted from the taxable base. Another advantage to using the broadest possible base is that it will maximize the federal government's recapture of presently-lost tax revenues from the so-called "underground economy." This will occur when such unreported income is spent in the "above ground economy."

Fairness. In the case of transaction-based consumption taxes, an often-voiced concern is the potentially regressive impact of such taxes on lower income individuals. We believe, however, that any such impact can either be eliminated or at least satisfactorily mitigated by (a) low rating, zero rating or exempting certain necessities such as food and medicines, (b) providing income tax credits or increased personal exemptions and zero bracket amounts for such individuals, or (c) some combination of these techniques. Another fairness issue relates to the effect that imposition of a broad transaction-based consumption tax would have upon those sectors already burdened with excise taxes (e.g., alcohol, tobacco, fuels, tires, telephone service, etc.). It would seem appropriate to consider either repealing such taxes or at least reducing them by the amount of the new levy.

We hope that the foregoing suggestions are of assistance to the Committee in its deliberations on this important matter. On the specific subject of consumption-based taxation, we have included as an appendix hereto a more detailed discussion of the economic implications of consumption taxation, including an analysis of the European experience with VAT. I will be pleased at this time to address any questions you may have.

APPENDIX

SUMMARY OF THE ECONOMIC IMPLICATIONS OF CONSUMPTION TAXES AND THE EXPERIENCE OF WESTERN EUROPE

Prepared by Dr. Gordon Richards
Director of Economic Analysis
Taxation and Fiscal Policy Department
National Association of Manufacturers

I. ECONOMIC IMPLICATIONS OF CONSUMPTION TAXES

There has been comparatively less research done on the economic effects of consumption taxes than other tax provisions in the United States, in part because of lack of available data for the country as a whole. However, based in part on the experience in other countries and theoretical studies, it is possible to delineate several major effects.

1. Distributional Effects. One of the most pervasive (if not altogether justified) arguments that has been alleged against consummption taxes has to do with possible regressivity. This, however, is applicable mainly in the event that the tax is levied equally across sectors. The regressivity problem could be alleviated through differential rates on goods typically consumed by upper income brackets, or by lower rates on basic necessities, or by offsetting adjustments to the income tax. Although the relative tax shares of income brackets would probably be affected by consumption taxes, it is somewhat less clear that they would substantially shift the aggregate distribution of

income. In econometric tests gauging the impact of a VAT, consumption taxes are invariably found to be regressive, but when differential rates are used, they do not always have a pronounced impact on income distribution.

2. Effects on Prices. The proximate effect of consumption taxes is an increase in the price level. In theory, this should be a one-time-only outcome, since prices are marked up over tax costs but otherwise left unchanged. In practice, the situation may be more complex. Labor unions, confronting a decline in the real purchasing power of their members, may attempt to compensate for this by raising wages, setting a cost-push mechanism in motion.

The likelihood of "tax-shift inflation" taking place is undoubtedly greater in an environment characterized by loose monetary rather than by restrictive demand management policies. If the increase in the price level is not accommodated, real money balances (the nominal money supply less prices) will fall, leading to greater slack in the economy; hence, wage increases are unlikely. If on the other hand the consumption tax is accompanied by a one-time-only jump in the money supply, higher inflation will result only if wages are increased in response and monetary policy also accommodates the wage increases; if the subsequent wage increases are not accommodated, the effects on prices will be transitory.

3. Effects on Demand and Output. In the near term, consumption taxes induce a fall in demand, both because real money balances will decline and because the tax induces a shift from consumption to saving. The economy

therefore slows down under the impact of the decline in spending; the magnitude of the slowdown depends on the magnitude of the tax increase. However, interest rates also decline, primarily because of the weakness in credit demand associated with slower growth, but also because the Federal deficit declines, mitigating the "crowding out" process in credit markets, and higher saving raises aggregate liquidity. The decline in interest rates, possibly in conjunction with an easing of monetary policy, will provide greater stimulus to the economy, leading to higher growth. In the long-term therefore, the negative effects of consumption taxes on demand and output are likely to be transitory, while the positive effects are likely to predominate.

4. Effects on Investment. One of the strongest arguments in favor of consumption taxes is that they will tend to shift the mix of output toward greater capital formation. By taxing consumption, the taxes would induce consumers to invest more of their current income in financial assets, thereby raising aggregate liquidity and lowering the user cost of capital. This effect would be particularly marked in the event that the tax exempted (or gave a preferential rate to) spending on capital equipment.

5. Effects on Trade. Because of their effect on the relative prices of imports and exports, consumption taxes would tend to lower trade deficits. The price of imports would be raised, while the price of exports would be unaffected, since the tax would not apply to goods sold abroad. In essence, consumption taxes operate as a *de facto* tariff in terms of their effect on trade. This would raise real output in the short term, since imports would

decline, leading to a rise in the net export (exports less imports) component of GNP. The only scenario in which this would not occur would be if domestic prices rose sufficiently to outweigh the relative price change in traded goods.

6. Effects on Federal Revenue and the Deficit. Increases in consumption taxes probably represent a more effective way of reducing the deficit than other types of revenue increases such as income taxes, tax surcharges, etc. Consumption taxes, in addition to their direct revenue effect, also reduce the debt service costs of the Federal government by raising savings, as noted above. Conversely, income taxes do not have this effect, since taxpayers can react to the drop in income by drawing down their savings.

II. THE EXPERIENCE OF WESTERN EUROPE

In order to gauge the possible implications of consumption taxes, it may be worthwhile to overview the effects of such taxes in major West European countries, where they have been used extensively. Consumption taxes in Europe have generally consisted of Value-Added Taxes (VAT) levied at each stage of production. The VAT is levied on a sum equal to total value added (the difference between the value of a firm's sales and the value of material inputs to production) less purchases of capital equipment. While a VAT on gross income, i.e., one which disallows deductions for investment and depreciation would theoretically be possible, in practice the industrial countries using VATs have not made use of this option. The VAT is typically not levied at a uniform rate on all sectors, but rather is applied at differential rates across industrial categories. The only major exceptions have been Denmark, which has consistently levied a single-rate VAT, and the United Kingdom, where a uniform rate was established in 1979. In Sweden, which nominally has a single rate VAT, the effective rate nevertheless varies across sectoral lines since only a fraction of value added is subject to taxation for some categories of goods.

France In France, the VAT has been in effect for over three decades and represents the major form of taxation used in this country. The VAT accounts for 48% of the revenues of the central government, followed by 20% for personal taxes, 10% for corporate income taxes and 8% for the excise tax on energy. The differential rates of the VAT have been explicitly designed to mitigate the regressive impact of consumption taxes, and to change relative prices in order to support the government's industrial policy, which has been aimed at channeling resources into heavy industry and capital investment: a zero rate applies to exports, a reduced rate to business equipment, and an increased rate to luxuries. Despite the differential rates, the effect of the VAT has been to make the tax system substantially more regressive and partially offset the impact of progressive personal income tax schedules. The distribution of overall tax liabilities by income bracket is roughly U-shaped, declining at the middle income levels, but rising at the upper and lower ends of the income scale.

The major economic effect of the VAT has been to shift spending into durable goods and industrial equipment, and away from the light industries and luxury products. Because of the zero rate on exports, the VAT has tended to support the French balance of trade, and econometric simulations suggest that reductions in the VAT are likely to be associated with external disequilibrium. Because of the distinctive feature of the VAT in France, however, in particular its use as part of a concerted industrial policy, its relevance to the United States is somewhat limited.

Italy In Italy, the VAT represents a more recent innovation, having been initially adopted in 1973. Its introduction was delayed in part by the existence of any number of prior retail and excise taxes which the VAT replaced. Differential rates have been used both to support macroeconomic objectives and to offset the possible regressivity of the VAT. Currently, it is levied at five rates ranging from 2% to 35%, with most categories taxed at 15%. A zero rate, however, applies to exports and some domestic activities that are likely to result in greater export activity. Because of the differential rate system and special treatment accorded to certain categories of agriculture and small business, there have been substantial administrative problems associated with VAT. Not only are the costs of administration relatively high, but the failure to enforce record-keeping and the special treatment of accounting for small business has led to widespread evasion. It is estimated that VAT receipts have been reduced by 30% to 40% because of systematic evasion or inadequate accounting procedures by smaller enterprises. Conversely, in the parastate sector (nationalized or semi-public corporations) and in large manufacturing enterprises, evasion is estimated to be much smaller.

In terms of its economic effects, the VAT has been linked in some studies with the acceleration in inflation during the early 1970s, on the grounds that wages were raised in an effort to compensate for the increase in retail prices. However, the contribution of the VAT to the inflation rate in general appears to have been negligible, and in this respect it is significant that the rise in inflation in 1971-73 anteceded the implementation of the VAT. The other effects appear to have been more favorable. The relative price of exports and certain inputs to manufacturing declined, resulting in higher growth in these sectors and a better external trade performance. The VAT also tended to raise investment, since capital spending was now exempted from taxation, whereas it had previously been subject to a levy. The effects on the distributuion of income do not appear to have been particularly pronounced. Because of the differential rate structure, the VAT did not appreciably reduce the progressivity of the tax system.

United Kingdom The VAT in the United Kingdom also dates from 1973, and was adopted specifically in order to gain entrance to the European Economic Community. It incorporates several distinctive features, among them the relatively large number of sectors other than exports that are wholly exempted. To a large degree, this was due to the aim of replicating the pre-existing sales tax system as closely as possible under the VAT. Further, the rates have been changed on several occasions. Originally, the VAT consisted of a standard rate and several higher rates. In 1979, however, this was changed to a single rate of 15%; this was motivated less by equity or progressivity considerations as by the need to raise revenues, following the

Thatcher government's reductions in income tax rates.

Because the VAT yielded tax rates that were not dissimilar from those previously in effect, its economic impact is not thought to have been particularly pronounced. As in Italy, the VAT was blamed in some circles for accelerating the price rise in 1973-74. However, in view of the other factors affecting inflation at this time, in particular the OPEC crisis and the wage-price rebound following the breakdown of the Heath government's controls, the effect of the VAT on inflation was minor. The VAT, in conjunction with accelerated depreciation allowances which permit first year expensing of capital equipment, substantially raised the rate of return on investment. While the ability of the VAT to boost investment spending has been the object of some debate in Britain, the generally lower ratio of investment to GDP in this country does not reflect any failure on the part of the VAT, but rather is attributable to other economic factors. If anything the VAT appears to have partially offset factors such as high rates of wage increase and high interest rates which worked against capital formation. On the other hand, the VAT is actually more neutral toward capital formation in certain sectors than the preceding selective employment tax, which generally worked in favor of greater capital intensity. The VAT did not raise British exports as much as in other European countries primarily because the pound was allowed to float, while the other European currencies were pegged under the EMS system. Nevertheless, it did change relative prices in favor of greater export activity. A further distinctive feature of the VAT in Britain is that it is not estimated to have reduced the progressivity of the tax system, although this was achieved only through the inclusion of numerous exemptions.

West Germany In West Germany, the VAT was adopted in 1965, although a general transactions tax had been in force prior to this time. The VAT is levied at a normal rate which has fluctuated between 10% and 13%, and a preferential rate set at one half the normal rate. Exports are wholly exempted, and any number of other exemptions are allowed in health, education and other social services. In contrast to France, where the VAT has been used in support of industrial policy goals, in Germany the use of preferential rates and exemptions has been aimed more at social welfare goals. Also, in contrast to Italy, the system of administration has militated against evasion, with the result that German authorities can point to almost universal compliance.

The economic effects of the VAT are generally adjudged to have been favorable. The German economy achieved high rates of growth in exports and investment during the period in which the VAT was in effect, although other factors contributed to this. The VAT did, however, shift the allocation of income between savings and consumption; in this respect, it is generally credited with increasing the savings rate and raising the liquidity ratio of the German economy. There is considerable evidence to indicate that the VAT had no effect on inflation. Despite the one-time increase in retail prices, the government secured an agreement for wage restraint by the major unions, with the result that the VAT-induced price increases were not transmitted to unit labor costs. The result was that in 1966-67 after the VAT was adopted, the rate of inflation actually declined. Various estimates have been made as to the effects of the VAT on the distribution of income. While the government estimated that the VAT was essentially neutral, some private sector studies claimed to have found an increased regressivity in tax burdens. Nevertheless, if the progressivity of the tax code was affected, the magnitude by which this took place was exceedingly small.

The Netherlands In the Netherlands, the VAT was phased in during the late 1960s as part of a general overhaul of the tax code; it replaced a complex series of consumption taxes, and is widely credited with having achieved a major simplification of the tax structure. A relatively large share of social services, including health, rents and insurance have been wholly exempted. Most exports are also zero rated, due to the substantial share (roughly half) of aggregate economic activity comprised by exports. A preferential VAT of 4% is levied on basic necessities, while other categories are taxed at 18%. The VAT in the Netherlands has been considered to be more neutral with respect to specific industries than comparable taxes in other countries.

In terms of its economic effects, the VAT has tended to raise exports. For this and for other reasons, the Netherlands has enjoyed large trade surpluses during the period in which the VAT has been in effect. If anything, policy makers have had reason to believe that the combination of the zero rating on exports and the normal VAT on most imports (except imported inputs to exporting industries) has on occasion put too much upward pressure on the exchange rate. Studies of compliance in the Netherlands have concluded that evasion has resulted mainly from administrative complexity and difficulties in record-keeping. Non-compliance was estimated in 1976-77 as amounting to only 1% of total revenues, however, a lower figure than in much of Western Europe. The effects on the distribution of income are considered to have been minimal. Although the VAT has not been neutral, as its framers originally claimed, its regressivity has been offset by other policies, with the result that the Netherlands has maintained one of the most egalitarian distributions of income in the world. The VAT is estimated to have engendered a one-time increase in the price level of approximately 3%, although this figure cannot be regarded as fully reliable inasmuch as the period during which the VAT was introduced coincided with a major jump in wages following the liberalization of wage controls. By the early 1970s, however, whatever impact the VAT may have had on inflation had been offset by a combination of wage restraints and more restrictive macroeconomic policies, with the result that the Netherlands has been able to hold its inflation rate below the European average.

Implications of European Experience The experience with the VAT in Western Europe has a series of implications vis-a-vis the use of consumption taxes in the United States.

1. The VAT has generally been subject to less resistance than personal income taxes. Compliance rates have normally tended to be higher, notwithstanding the experience of countries like Italy where evasion has been facilitated by inadequate administrative procedures. The greater compliance with the VAT and the comparative absence of widespread resistance stems in part from its lower "visibility", *i.e.*, the fact that it is collected on the basis of sales rather than income.

2. The VAT should not be viewed as inherently inflationary, despite the one-time increase in consumer prices. Instead, if consumption taxes are accompanied either by wage restraint or by non-accommodative monetary

policies, there is no lasting impact on inflation. Moreover, studies which have purported to find a relationship between the VAT and inflation have frequently failed to differentiate the impact of the tax from other factors. In the United States, the current high level of unemployment and other factors working against inflation make it highly unlikely that consumption taxes would have any significant effect on the rate of inflation.

3. By changing relative prices, however, the VAT has tended to produce a more favorable tax treatment of investment and exports. Further, the VAT has frequently generated an increase in the savings rate.

4. The regressivity problem is not necessarily a serious one. The use of differential rates and the exemption of basic necessities has meant that the VAT has not resulted in a significantly more regressive distribution of income or of tax liabilities.

STATEMENT OF DAVID MITCHELL, PRESIDENT, SMALLER MANUFACTURERS COUNCIL, PITTSBURGH, PA

Mr. MITCHELL. Thank you, Mr. Chairman.

I am the president of a small plastic parts manufacturing company, and I am also appearing here as the president for 1984 of the Smaller Manufacturers Council, which is an association of more than 1,700 small businesses in the Greater Pittsburgh area.

I would like to particularly applaud this committee for the efforts in having people come and give this testimony. I have been impressed by the amount of time that you have devoted to the hearing of various views that you have brought before you today.

The first priority, to prepare for meaningful tax reform it is imperative to first limit Federal spending, balance the budget, and begin paying off the national debt. A tax increase has never resulted in reduction of Federal budget deficits. Raising taxes is not a way to control deficits.

We recommend you use the tax reforms to help U.S. business compete with our foreign counterparts for world markets. Business, and small business in particular, is where the jobs are created. Begin a systematic program to reduce the corporate net income tax, leading to eventually abolishing it. All corporate or business taxes are passed on to the consumers as increased prices; such price increases reduce the ability of U.S. business to compete with foreign businesses which do not have as great burdens.

As President Reagan has stated, "The corporate net income tax is hard to justify." At least begin a systematic program to reduce the corporate net income tax, to help U.S. business to become better world competitors, help keep jobs here, and help reduce our growing balance-of-payments deficit. Why pass taxes through our businesses to the consumers, who will pay them in the end, anyway, and make our businesses less competitive as a result.

Most payroll taxes have been effectively hidden or isolated from our employees. Reduce the burden of payroll taxes on small business' competitive position. Since small businesses are generally labor-intensive, payroll taxes have a disproportionate impact on small firms. We oppose any further increases in payroll taxes.

We have offered in our written testimony four specific changes in IRS regulations to help ease the burden on small business. Small businesses pay taxes at extremely high effective rates, and we have offered three specific changes to help small business in this area.

We strongly oppose the value-added tax as discriminatory against labor-intensive and high-technology businesses. A simple flat personal income tax and a national sales tax could provide a fairer distribution of tax burdens after spending has been cut to balance the budget.

Thank you.

[Mr. Mitchell's written testimony follows:]

Aug 9

TESTIMONY

to

U.S. Senate Tax Reform Panel

PRESENTED BY:

David Mitchell, President
Smaller Manufacturers Council

August 9, 1984

TAX REFORM

My name is David Mitchell. I am President of Tri-State Plastics, Inc. of Glenwillard, Pennsylvania, a small plastic parts manufacturing company. I am here as well as President of the Smaller Manufacturers Council, an association of more than 1700 small businesses in the Pittsburgh area. Thank you for addressing this most vital subject and for this opportunity to offer our views, concerns and suggestions for your guidance in helping the 14,273,909 small business in this country to improve our economy.

There is much of the needed tax reform which must be accomplished with congressional legislative action. So, a major role of the Senate Finance Committee and the Executive branch must be to exert a strong leadership role to convince Congress of the proper legislation needed to provide wise reform to our tax system.

Limit Federal Spending - the top priority. Never in our history has a tax increase resulted in reduction of our Federal Budget deficit. Raising taxes is not a way to control the deficits. That simply turns out to be a way to provide more funds to be spent. The top priority in preparation for meaningful tax reform must be to reduct Federal spending and get the spending budget under control by adopting simple guidelines:

1. Don't spend more than is received in taxes.
2. If taxes are increased in any area, assure that all increased revenue will go directly to deficit reduction, and none to increased spending until we have eliminated our deficits.
3. Stimulate economic strength in the productive sectors of

our economy by reduction of tax burdens to promote better worldwide competition, and eliminate ineffective Federal stimulative spending programs.

4. Develop and follow a long-range plan to pay off the U.S. Federal Debt.

Use tax reforms to help U.S. Business compete with our foreign counterparts for world markets.

1. All corporate or business taxes are passed on to the customers as increased prices. Such price increases reduce the ability of U.S. business to compete with foreign businesses who do not have as great burdens. As President Reagan has stated, the CNI tax is hard to justify. At least begin a systematic program to reduce the CNI tax to help U.S. business become better world competitors, help keep jobs here and help reduce our growing balance of payments deficits. Why pass taxes through our businesses to the consumers who will have to pay them in the end anyway, and make our businesses less competitive as a result?

2. Let's stop talking about business' fair share of the tax burden, and start thinking about what is fair for America in the worldwide competition we face. If we are to regain a competitive position in much of the world market place, we must reduce unfair burdens on our business such as pass-through taxes, excessive regulations, and costly protection against unexpected government punishments.

3. Reduce the burden of payroll taxes on small business' competitive position. Most payroll taxes have been effectively hidden or isolated from our employees. An employee is primarily concerned with take-home pay, and is less affected by the tax burden

which the employer pays for him and must include in prices of the products or services to customers. Employees are largely unaware of the enormous tax burdens placed on our U.S. businesses on which they depend for their jobs.

Payroll taxes have a disproportionate impact on small business because small firms are generally labor intensive and a larger portion of their total payroll is subject to these taxes.

Payroll taxes now constitute approximately 33% of Federal revenue collections. But perhaps even more significant is their growth. Between 1970 and 1990, there have already been or are now scheduled to be implemented 9 FICA (Social Security) rate increases totalling 60%, 19 FICA base increases totalling an estimated 677%, 3 FUTA (Unemployment Compensation) rate increases totalling 94%, and 3 FUTA Base increases totalling 133%.

Congress has relied heavily on payroll-based taxes to fund social policy programs without consideration of how pay roll-based taxes impact on labor-intensive small firms.

Payroll taxes must become part of the broad tax policy debate. Despite immediate as well as long-term problems of funding Medicare, Social Security, and unemployment compensation reserves, Congress must be convinced that the small business community can no longer support this continuing upward spiral. Therefore, we oppose any further increase in payroll taxes.

Several changes in the IRS regulations would ease the burden of payroll taxes on small firms while in no way reducing the responsibility of the business owner:

1. Amend IRS regulations by changing the threshold for making payroll tax deposits from $3,000 to $7,500.
2. Employers with gross annual deposits of less than $75,000 will be considered to have complied if the deposit is not less than 90% of the taxes for the period.
3. Penalties should not be assessed against the potential shortfall of taxes owed for 1st penalties in a fiscal year and when the gross payroll rules change due to increases in total payroll.
4. Notification of penalty and taxes past due should include a detailed account of computations.

Because they are labor, and often inventory intensive, small businesses pay payroll, income, and other taxes at extremely high effective rates. These effective rates are far in excess of the average for all business. We urge Congress and the Administration to undertake a comprehensive review of the tax structure to correct this disparity in effective tax rates and eliminate unnecessary complexities in the tax treatment of small businesses. While tax reform is of great concern to small business, it should not be used as an excuse to increase taxes or implement taxes of any kind on small firms in view of their already high effective tax rates. Rather, reform needs to take the approach of helping reduce the high burden taxes place on small businesses. Immediate and appropriate actions to help rectify the current inequities are:

1. Graduated Income Tax

Replace the present corporate tax graduation schedule with a graduated rate scale, specifying a graduated rate schedule up to $500,000.

2. Used Equipment ITC (Investment Tax Credit)

We propose that the tax credit limitation be increased in the near term to $50,000.

In the long term, we find no reason for retaining any distinction for purposes of the investment tax credit between new and used equipment; the limitation should be eliminated.

3. Accumulated Earnings Tax

Since this tax is assessed only on small businesses, it ignores potential economic and business down turns, and was instituted when tax rates on "unearned income" was in excess of 50%. This section of the Internal Revenue Code should be repealed.

We strongly oppose the Value Added Tax as discriminatory against labor intensive and high technology types of businesses.

After spending is reduced to balance the budget, it is essential to provide extreme simplification to our tax system such as a simple flat tax to allow the average taxpayer to fully understand the system and feel all Americans are asked to pay a fair share. A uniform simple consumption tax such as a national sales tax may be the best way to fairly distribute the tax burden.

On behalf of my company and the Smaller Manufacturers Council, I thank you for this opportunity to present testimony for your consideration. We stand ready to supply additional information and help answer questions you may have. We are anxious to have a continuing role in development of tax reforms for our country.

STATEMENT BY NICHOLAS E. CALIO, VICE PRESIDENT, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS, WASHINGTON, DC

Mr. CALIO. Thank you, Mr. Chairman, members of the committee.

Mr. Chairman, the National Association of Wholesaler Distributors, like the other members of the panel and the previous people who appeared this morning, commend the committee for the leadership role it is assuming in looking at tax reform. We support a comprehensive review of the tax system, because there are problems which are well recognized that plague the current system.

NAW is in the process of attempting a rational assessment of the impact of the various—and it seems evergrowing—number of tax reform proposals on both our industry and the economy in general; a process, I might add, which is made more difficult by the fact that there is little in the way of hard evidence to give any indication of what the actual impact of these proposals would be in the long run.

Hence, we are not here today to recommend one existing proposal over another; rather, we are here to provide recommendations on the process by which reform is approached, since we are concerned that there might be an infatuation with reform for reform's sake and that that infatuation might overwhelm the deliberative process and undermine the purpose of reform.

For this reason, to state the obvious, we think that the process has to begin with a careful identification and analysis of the problems in the current code. Working from that analysis, we believe that some preliminary policy conclusions must be reached by this committee and other policymakers charged with reforming the Tax Code. Without that kind of consistent philosophical or policy base, we are going to end up with a different code, not a better code.

After that, we believe what is necessary is to construct a framework for decisionmaking which is made up of certain sound tax policy principles, and to judge any of the reform measures against that framework to see whether in fact they would better the Tax Code or better the situation that we now face.

While NAW hasn't reached any conclusions as to what the whole of tax reform should look like, if it in fact takes place, we have reached some preliminary conclusions with respect to some of the parts it should contain or some of the things it should do.

The principle of those are that the tax system should be revenue neutral. It should broaden the tax base, reduce marginal tax rates, reduce the progressivity of the current tax system significantly, eliminate or reduce the wide disparity in effective tax rates paid by businesses, and reduce the bias in the current system against saving and investment.

I would just like to say in conclusion that a critical matter for our industry is that of high effective tax rates. We believe that any tax reform proposal must look at the wide disparity in rates that businesses pay right now.

The Joint Committee on Taxation study of Effective Tax Rates for 1982 taxes showed that our industry paid a rate of over 36 percent; hence, any kind of a surtax, or any kind of add-on tax would have a disproportionate impact on us.

I am also told that the joint committee study for 1983 may in fact show us to have the highest effective rate of any group studied.

Thank you very much.

[Mr. Calio's written testimony follows:]

NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

STATEMENT OF

Nicholas E. Calio

Vice President-Government Relations

National Association of
Wholesaler-Distributors

BEFORE THE

Committee on Finance

United States Senate

ON

Major Tax Reform Options

August 9, 1984

1725 K Street, N.W. • Washington, D.C. 20006 • 202/872-0885

Summary of the Statement of
Nicholas E. Calio
Vice President-Government Relations
National Association of Wholesaler-Distributors

Before

The Committee on Finance
United States Senate

Hearings on Major Tax Reform Options

August 9, 1984

1. The National Association of Wholesaler-Distributors (NAW) supports a comprehensive review of the federal tax system. The current system is overly-complex, inequitable, and inefficient.

2. Since NAW is currently in the process of assessing the impact of the growing number of tax reform proposals on the wholesale distribution industry and the economy in general, we are not in a position to recommend one proposed reform over another at this time.

3. We believe, however, that the subject of major tax reform should be approached only after the problems plaguing the current tax structure are carefully identified and analyzed and only after guidelines are carefully constructed by which major tax reform proposals should be judged. Such a framework for decisionmaking will provide the best chance for structuring a better tax system than the one that is now in place.

4. Any tax reform proposal, to be acceptable, must at a minimum be revenue neutral; broaden the tax base; reduce the wide disparity in effective tax rates paid by businesses; simplify the current code; eliminate the bias in the current system against investment and savings; treat various forms of savings and investment essentially equally; and bring certainty to the tax system so that tax liabilities do not change every year.

I. INTRODUCTION

My name is Nicholas E. Calio. I am Vice President-Government Relations of the National Association of Wholesaler-Distributors. I appreciate the opportunity to appear here today to submit this testimony on behalf of NAW and its members.

The National Association of Wholesaler-Distributors supports a comprehensive review of the federal tax system. That a thorough rethinking of the tax structure is necessary is beyond question and NAW commends the Chairman and the entire Finance Committee for holding these hearings and thereby undertaking a lead role early in this crucial debate.

II. THE NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS AND THE WHOLESALE-DISTRIBUTION INDUSTRY

The National Association of Wholesaler-Distributors is a federation of 119 national wholesale distribution associations (see Appendix A) which have an aggregate membership of approximately 45,000 wholesaler-distributors with 150,000 places of business nationwide.

NAW's membership is dominated by small to medium-sized businesses and is responsible for over 60% of the $1.4 trillion of merchandise which flows through wholesale channels annually. NAW members also employ a comparable percentage, or 3 million, of the 5 million Americans who work in wholesale trade. Thus, while the individual firms which our organization represents are small- to medium-sized businesses individually, their collective economic importance is significant.

According to the most recent figures available from the Internal Revenue Service (1979), corporate wholesale distribution firms had pre-tax profits of $18.6 billion and paid $7.3 billion in taxes. The annual study by the Joint Committee on Taxation shows that the industry paid an effective tax rate of approximately 36 percent in 1982, one of the highest of any group studied.

III. TAX REFORM AND RESTUCTURING

The current high political profile of tax reform and alternative tax structures is indicative of widespread dissatisfaction with our current system of taxation. Indeed, the sheer volume of proposals for tax reform bespeaks fundamental problems which need to be examined and, hopefully, corrected.

The National Association of Wholesaler-Distributors is currently attempting to rationally assess the various (and seemingly ever-increasing number of) tax reform proposals and their impact on wholesaler-distrtibutors and the economy in general both on its own and through its participation in the Coalition To Reduce High

Effective Tax Rates. As a result, we are not in a position to recommend one alternative over another at this time.

NAW's participation in these hearings is motivated in part by our concern that tax reform, if advanced, can become a vehicle for counterproductive tax increases. It is also motivated by our concern for the process through which tax reform and alternative tax structure proposals will be considered since we fear that an infatuation with reform for reform's sake could undermine the purpose of changing the tax structure.

Therefore, NAW will first address the systemic problems undermining our current system of taxation. These problems must be carefully identified and analyzed before the merits of tax reform itself or any specific proposal can be properly addressed.

Based upon our analysis of those problems, we will then set forth a framework for decisionmaking, constructed of sound tax policy prinicples, within which any fundamental reform package should be judged.

At the outset, I would note that no single proposal is likely to meet these guidelines exactly. Nonetheless, by consciously establishing a consistent framework for examining the numerous proposals being advanced, the chances of structuring a better tax system - out of one and perhaps more of the proposals - will be increased with the result that Congress will not have to reexamine the Tax Code every year.

IV. PROBLEMS WITH THE CURRENT TAX SYSTEM

The basic problems with our current system of taxation are both well-recognized and simply stated -- it is almost hopelessly complex, inequitable, and inefficient. These characteristics are, of course, inter-related and give rise to a host of subsidiary problems.

A. Complex

The complexity of the current tax code is legendary. It is comprised of thousands of pages of statutory language and regulations which have been adopted over the years without any consistency of purpose. Many Code provisions and rules must be cross-referenced to numerous other provisions and regulations to determine if and when they apply, to what extent they apply, and to what effect. The result is that the burden of compliance is excessive and few ordinary taxpayers and businesses can understand the tax laws.

Moreover, the complexity problem is compounded by continuing, often annual, changes in the law (such as the recently enacted Deficit Reduction Act of 1984) which make it a challenge even for the experts to accurately follow and interpret the law and which make consistent business planning difficult to say the least.

The current morass of statutory provisions and regulations particularly penalizes ordinary taxpayers and small businesses who cannot afford expert professional help. Concemitantly, it unnecessarily drains the resources of those who can afford expert help and who could better invest their money in some productive use.

The complexity of the current system is largely responsible for both the public perception that the Tax Code is unfair and the fact that the law is unfair since many of the Code's provisions produce unintended and contradictory effects which result in similarly-situated taxpayers being treated differently.

B. Inequitable

The current tax system is grossly unfair. The numerous deductions, exclusions, and credits which add to the complexity of the Code have been used as tools to influence "economic" decisions. However, the ad hoc approach by which these provisions have been implemented over time has resulted in an uneven and illogical distribution of benefits. Consequently, wide disparities exist in the effective tax rates paid by various industries and by various companies.

For instance, labor and inventory-intensive industries, like wholesale distribution, make relatively nominal use of most of the capital cost recovery provisions in the Tax Code which enable other industries and companies with like net financial income to pay much lower rates of tax. The reason is that 80 percent of the wholesaler-distributors' assets are in inventory and accounts receivable, not in capital assets. This amounts to a subsidy for certain types of business activity and investment; absent compelling justification, the tax laws should not so favor one type of business over another.

As previously noted, the respected effective tax rate studies which show that some businesses pay very low effective tax rates document that the wholesale distribution industry, among others, pays a high effective rate -- in our case over 36 percent. This disparity unfairly places the small- to medium-sized businesses which comprise NAW's membership at a competitive disadvantage and led NAW to become a founding member of, and Executive Secretariat to, the Coalition To Reduce High Effective Tax Rates. The Coalition, which is also being represented in testimony today, is committed to achieving a substantial reduction in the high effective rates paid by some businesses. The Coalition's testimony fully details the inequities of high effective tax rates and NAW would like to associate itself fully with that testimony.

It is important to emphasize that the high effective tax rate issue is of concern not just to wholesaler-distributors, but to the small business community per se.

In June of this year, a landmark Small Business National Issues Conference was held under the sponsorship of the American Institute of Certified Public Accountants, the Chamber of Commerce of the United States,, the National Federation of Independent Businesses, the National Small Business Association, and Small Business United.

Over 100 delegates, representing a balanced cross-section of American small business, nominated by these sponsoring organizations* participated in framing a priority small business action agenda.

Against this background, it is particularly telling that inequitable effective tax rates were singled out by the delegates as their third highest priority, out of over 90 issues presented for evaluation during the conference.

The conference's preliminary report states:

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*The delegates represented themselves, however, not the nominating organizations.

> The Congress and Administration are urged to undertake a comprehensive review of the tax structure to correct the disparity in effective tax rates which presently exists ...
>
> ...Equity, fairness, simplicity, and parity in effective tax rates for all businesses should be the guiding principles followed in addressing this issue.
>
> While tax reform is of great concern to small business, it should not be used as an excuse to raise taxes or implement taxes of any kind on small firms in view of their already high effective tax rates.

C. Inefficient

Theoretically, the tax system should affect free market economic decisions as little as possible; that is, economic decisions made under a particular tax structure should closely resemble the economic decisions which would be made in the absence of taxation. In practice, the current system utterly fails in this regard.

It provides disparate treatment of different forms of investments, penalizes savings, and encourages consumption. As a result, personal and business decisions are often made on tax rather than economic grounds and, while the system produces revenue as intended, it also produces a host of unintended side effects which disrupt to an unacceptable degree the normal and healthy functioning of a free-market economy. Thus, there can be little doubt that the system is in need of an overhaul.

V. ELEMENTS OF SOUND TAX POLICY WHICH PROVIDE A FRAMEWORK FOR JUDGING TAX REFORM/ALTERNATIVE TAX STRUCTURE PROPOSALS

It is critical that an overhaul of the current tax structure be undertaken cautiously and only after its practical impact is fully considered. While this may be stating the obvious, the admonition is nonetheless important since tax reform history teaches that the process often fails to move forward in a deliberate, philosophically consistent manner which fully accounts for the practical, long-term impact of the legislation. Clearly, nc reason exists for enacting any tax reform or alternative tax structure porposal unless it substantially reduces or eliminates the problems which exist under present law.

The National Association of Wholesaler-Distributors thus submits that any tax reform/alternative tax proposal should be judged by the following minimum requirements:

A. Revenue Neutral

The proposal should be revenue neutral. One of NAW's greatest concerns is that an overall "tax reform" will once again, as it has so often in the past, prove a euphemism for "tax increase."

We must recognize that we are running deficits because America spends too much, not because it taxes too little. Again, history is a guide. Despite the fact that the Tax Equity and Fiscal Responsibility Act of 1982 imposed one of the largest tax increases in our history, both deficits and interest rates rose significantly after its enactment. Further increasing taxes will only exacerbate pre-existing problems by adversely affecting productive economic activity while expanding the size of a still-bloated Federal government. In addition, raising taxes under the guise of tax reform further delays the point at which the country faces the fundamental question of how much it can really afford to spend and how much it can really afford to tax.

B. Broaden the Tax Base and Reduce The Tax Rate

Broadening the current tax base and reducing the applicable tax rates are appropriate tax policy goals which should be part of any acceptable tax reform proposal. The current tax base is artificially constricted and current rates are too high. Hence, too few taxpayers pay taxes at too high a rate.

Any new tax code should reduce the wide disparity in tax rates experienced by businesses under current law; appropriate reductions in present rates would at least moderate the upper tier of current disparities.

Concomitantly, an alternative tax structure should eliminate or reduce rate graduation. Progressive rates discourage productivity and work. In short, a new tax system should reward enterprise, initiative, and thrift, or be rejected.

C. Simplicity

All proposals should be judged by their relative simplicity. NAW doubts that any fair tax code can be made simple in absolute terms, but we believe that it can - and should - at least be made straightforward and understandable enough so that the average personal and business taxpayer can understand it and plan to meet the tax liability it imposes. Such simplification will ease the burdens of compliance and insure that taxpayers do not pay more taxes than required simply because they lack the resources or expertise to understand the limits of their liability.

D. Elimination of the Bias Against Investment and Savings and Neutrality Towards Various Forms of The Same

A primary goal of a new tax system should be to eliminate the current structure's bias against investment and savings.

In addition, the Tax Code should not, as current law does, discriminate without justification against certain types of investment and savings. For example, the investment tax credit is available under the present system for some investments and not others, while the cost recovery period for investments in machinery is, for instance, substantially shorter than the cost recovery period for investments in warehouses and other commercial structures. Similarly, some savings are taxed when they accrue while others are taxed only when they are consumed.

E. Certainty

Any alternative tax structure should provide certainty. Reform should not be undertaken or enacted unless and until it is relatively clear that the system will not require the kind of constant tinkering which has plagued the current system, particularly over the last 15 years. Constant changes in the tax laws not only make accurate interpretation difficult, they seriously impede sound business planning.

VI. CONCLUSION

Far more is wrong than right with the current tax system. Its detrimental impact on our economy is incalcuable, albeit significant. Hence, a close and careful examination of the system as a prelude to reform is highly desirable. For this reason, we again commend the Finance Committee for undertaking these hearings.

At the same time, the need to do the job carfully and completely cannot be overemphasized. Tax reform for the sake of tax reform -as well as tax reform for the sake of revenue increase - will do more damage than good.

On behalf of NAW, thank you again for the opportunity to present our views.

The CHAIRMAN. If Mr. Howard, who is not present, would like to file a statement, obviously he may do that.

I don't have any questions; I think you have pretty well summarized. I have some trouble with the national sales tax. As you indicated, I think we have to look at the political realities around here, and that would seem to me to be very difficult to do.

As I understand, none of these do anything with excise taxes. I don't think yours does either. You don't do anything with excise taxes, do you? You don't repeal excise taxes, do you?

Senator BRADLEY. No.

The CHAIRMAN. That's something we need to look at, excise taxes, if that's a fair tax, because I know there are some who feel a little burdened by some of the excise taxes we increased in 1984 and others that we increased in 1982, including liquor, cigarettes, telephone, and others.

Does anybody else have anything you want to add? If not, I'll yield to Senator Bradley. Do you have any questions?

Senator BRADLEY. Just very briefly.

Mr. Calio, you say that the wholesalers and distributors of the country pay an effective tax rate of 36 percent.

Mr. CALIO. Yes, sir.

Senator BRADLEY. And you think we should move to a tax system with a much lower rate of tax, right? And that means in your case a much lower effective rate.

Mr. CALIO. Yes.

Senator BRADLEY. Well, that's good news. I hope you look carefully at the corporate side of FAIR tax. The top rate is 30 percent.

Mr. CALIO. I understand that. Most of the proposals that are on the table would, at least on the surface, lower our effective tax rate, and of course we like that. We think there needs to be further examination all the way around, however, as well as of what is kept and what isn't kept. Right now there are none of the preferences in the code, or there are very few preferences in the current code, that wholesalers and distributors can take advantage of. Consequently, on the same net financial income as another company, they are paying in many cases 30 or 25 percent more tax. That indicates to us that inefficiencies and inequities exist in the current code.

Senator BRADLEY. Are your members aware of the great disparity in effective tax rates?

Mr. CALIO. They are, Senator.

Senator BRADLEY. In other words, they feel they are really paying heavily?

Mr. CALIO. They do, and it's a huge issue with them. I might also point out that it is not confined to our industry, as some of the other witnesses have pointed out. There was a national Small Business Conference in Washington in June which brought all different kinds of small businessmen together under the auspices or under the sponsorship—although it wasn't the views of the Chamber—of the National Federation of Independent Businesses and some other groups. They looked at over 90 issues, and they were asked to rank those issues in order of importance. High effective tax rates was rated No. 3.

Senator BRADLEY. Thank you.

The CHAIRMAN. I think Mr. Mitchell indicated that you are concerned about any tax increase, because we are going to spend the money. And I think that certainly is a problem.

Mr. MITCHELL. Yes, sir.

The CHAIRMAN. But again, there are political realities. I am not certain, as I said yesterday or maybe earlier today, how we can really determine which direction to go until we know who the players are going to be next year. I mean, the players today—some may be or some may not be here. And the player at the White House may or may not be there. So it is all going to depend a lot on what happens in November. You may have a preference, and we won't get into that, but it is going to make a difference on how we proceed, I think, because different Presidents will have different philosophies on revenues, spending, and we will have to adjust to that. Plus, I don't know what the mix of Congress may be.

But there is no doubt about it, it is much easier to spend money or reduce taxes than it is to raise revenue or cut spending. But it seems to me, as Paul mentioned earlier, it may be some combination. I mean, in the real world around here you can't have your way if you've got different philosophies who dominate in different parts of the Capitol.

Mr. MITCHELL. Mr. Chairman, I would like to point out that at this National Small Business Issues Conference that was held in June, the No. 1 priority was the concern with the deficit spending and the problems with the deficit. And so I'm really emphasizing that as well from our association standpoint. We are very concerned, the small business community is quite concerned, about the problems of spending, and we feel that that's the first priority, to get control of the spending, that tax reform should not be used as a way of doing that.

The CHAIRMAN. But it might take some combination. If you are going to get it through, you might have to package something that would have, hopefully, a priority on spending restraint, but some tax reform or maybe even some revenue change that might be called increases. We have tried different names like enhancement and reform, but if your taxes go up I guess it is an increase.

Paul?

Mr. HUARD. Yes, if I might, Mr. Chairman.

I would like to make one additional observation on the colloquy that took place between Nick and Senator Bradley. I do this because I sometimes get tired of walking around with a jersey that says "Big Business" on my back.

We have about 13,000 members, and, by fraction, only 500 of these can be in the Fortune 500. Indeed, about 90 percent of our members are small businessmen.

And when you talk about lowering the effective rate, I would like to point out that under the FAIR tax if you have a small business that is incorporated, with taxable income of exactly $50,000, under the current system of graduated corporate income tax rates on the first $100,000 of income, they are going to pay a tax of around $8,000. They are going to pay $15,000 under Senator Bradley's bill. Now, if that is a reduction in effective rates, I need a reeducation, and I'll go back to Georgetown and get my degree again.

But, you know, it's that kind of problem. With all of these overhaul provisions which are ostensibly revenue neutral, little things like that are going to have to be fixed, because they are not politically very viable. I don't think you can do that to small businesses. That caused me to make my observation as to what is viable and not viable.

Senator **Bradley**. Mr. Chairman?

The **Chairman**. Senator Bradley.

Senator **Bradley**. Since you raised it, let the record reflect that only 14 percent of all small businesses are incorporated; 86 percent of all small business are taxed as individuals and will get the full benefit of the Bradley-Gephardt bills very low individual rates.

Mr. **Mitchell**. But why should there be a difference between the two ways of doing business? is another good question.

The **Chairman**. Well, there are those little details that will have to be worked out. [Laughter.]

What we will do now is recess until September, and then we will announce tomorrow—again, we will try not to conflict with that hearing that Ture mentioned—the dates of a couple of more mornings of hearings, because there are about 30 other witnesses plus a number of House Members to testify.

Thank you very much.

]Whereupon, at 1:15 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF CHIEF COUNSEL FOR ADVOCACY

STATEMENT OF

FRANK S. SWAIN

CHIEF COUNSEL FOR ADVOCACY

U. S. SMALL BUSINESS ADMINISTRATION

FOR

COMMITTEE ON FINANCE

U. S. SENATE

AUGUST 9, 1984

I appreciate the opportunity to comment on fundamental tax reforms. I believe fundamental tax reform is crucial if small businesses are to vigorously continue their crucial role in economic growth and job generation.

Office of Advocacy

The Office of Advocacy was created within the Small Business Administration (SBA) under Public Law 94-305 in June 1976. As Chief Counsel for Advocacy, my responsibilities include representing the views and interests of small businesses before other Federal agencies. I am also charged with monitoring the implementations of the Regulatory Flexibility Act (RFA), Public Law 96-354, to assure that small firms and small entities receive appropriate consideration in the regulatory process.

We are also statutorily mandated to develop a small business data base and to foster analytic information from which small business policy may be developed. Ultimately, this data base should be helpful in examining tax issues and proposals as they relate to the small business sector of the economy.

We also seek to provide information on small business and foster discussion of small business issues. For example, we recently held a symposium on economic research relating to small business issues. One of the major topics of discussion at that symposium was tax reform.

Tax Reform and Small Business

Fundamental tax reform is of basic importance for small businesses. The small business community is coming to view the existing system as a disincentive to savings, investment and work. The existing system with its double taxation of savings and corporation profits discourages capital formation and growth for small businesses. Furthermore, because many small firms are labor intensive rather than capital intensive, the tax incentives for capital investment built into the current system are not as relevant for small firms.

Even more importantly, the current system is extremely complex and becoming virtually unworkable for small businesses. One only has to look at the recently enacted Deficit Reduction Act of 1984 to view the complexity of this system. Such complexity greatly increases the compliance burdens of small business as well as the costs of tax planning. The paperwork burdens generated by the existing tax system are also staggering. The Federal Government estimates that approximately 90 percent to

95 percent of the 592 million paperwork burden hours (defined as the time to fill out requested forms) imposed by the Treasury Department are attributable to the Internal Revenue Service (IRS). From a small business perspective, this complexity with its attendant costs and burdens is by itself a basic defect of the system. We should add that these complexities are often the result of the law itself.

Alternative Structures for Tax Reform

As you are aware, proposals for fundamental tax reform have centered on two basic types of structural revisions: a comprehensive income tax and a comprehensive consumption tax based on consumed income. Both are aimed at lowering marginal tax rates and expanding the income tax base by eliminating many tax preferences.

It is clear that both systems will involve benefits and costs for small businesses. Lower marginal rates and a simplified tax system will make it easier for small businesses to successfully use such a system. At the same time, broadening the tax base will require reducing or eliminating certain preferences in current law that were created to achieve certain economic or social goals. Consequently, certain benefits under the current system will no longer be available to small businesses. Pending tax reform proposals will, therefore, require small businesses to reexamine their operations and to adjust to the exigencies of the new system.

A comprehensive income tax will make the system more equitable by broadening the tax base through the elimination of preferences while retaining a progressive rate structure. This tax plan and lower rates will undoubtedly help small businesses and should encourage savings and investment. However, whether lower rates will compensate for the loss of existing preferences will depend entirely on the rates adopted, which in turn will depend on revenue needs. How this is accomplished will determine the ultimate benefits for small businesses.

The change to a comprehensive income tax will also improve economic efficiency by eliminating the distortions in the flow of savings and investment fostered by the existing system of preferences. This effect should substantially improve the flow of capital to small and growing businesses. In its purest form, it would also eliminate the double taxation of corporate profits by integrating individual and corporate income taxes.

Most importantly, small businesses will benefit from the simplification that comes with the comprehensive income tax. The new, simpler system will reduce compliance costs, as well as costs associated with tax planning and tax avoidance. These expenses, as well as time and energy (important commodities for small businesses), can then be utilized for business development and ultimately for economic growth. In the final result, the increased simplicity of such a system may be its ultimate benefit for small businesses.

The comprehensive consumption tax, like the comprehensive income tax, would broaden the tax base in exchange for lower tax rates. The comprehensive consumption tax would broaden the tax base by taxing all forms of compensation, expanding estate and gift taxes under some proposals, and disallowing interest expense deductions. It would also reduce or narrow the tax base by exempting all forms of savings and income from capital (unless consumed). Because of this exemption for savings, rates would in all likelihood have to be higher than comprehensive income tax rates in order to raise the same amount of revenue.

By exempting savings and income generated from savings from taxation, the comprehensive consumption tax would eliminate the double taxation of savings. The consumption tax, like the comprehensive income tax, would also eliminate double taxation of corporate profits by integrating corporate and individual income taxes.

The comprehensive consumption tax is also a prime means of simplifying the tax system which, as I have indicated above, will be a great benefit for small businesses. Furthermore, most of the benefits of the comprehensive income tax apply to the consumption tax. The elimination of taxation on savings and unconsumed earnings from savings will substantially aid small business capital formation and growth. On the other hand, rates higher than those under a comprehensive income tax would have to be accepted, as would stronger estate and gift taxes. There will also be increased complexity created by the requirement to account for all wealth flows.

Adopting any system of fundamental tax reform will create substantial problems during the transition from the old to the new system. Upon immediate enactment, economic dislocations could be substantial and adjustments difficult. Investments and contracts profitable under the old system could be made unprofitable by the new. Taxpayers who engaged in certain tax-favored investments or activities under the old system could experience substantial declines in value or income.

This problem would be magnified where the particular investment or activity had been deliberately adopted by Congress to achieve specific policy objectives. For example, in a pure comprehensive income tax system, the following changes from the current system would have this impact: the elimination of accelerated depreciation, thereby increasing the effective rate of tax or activities such as real estate, certain agricultural activities and the extraction of minerals; the taxation of all realized capital gains at the full rate; and the integration of the individual and corporate income taxes, which has its own transition problems.

A second problem of transition arises when income is earned under the old system but not taxable when the new system is implemented. One example would be capital gains, which under some pure comprehensive income tax proposals would be fully included in income. To be equitable, special rules would be needed for taxation of capital gains earned before the effective date of the new system but realized after that date.

Transition problems would have to be solved through grandfather provisions and phase-in rules. Any transition rules adopted could affect how small businesses adjust to the new system and could determine how small business would benefit from the new scheme. Nevertheless, we believe these transition problems are solvable and that the benefits ultimately to be derived from fundamental tax reform greatly outweigh them.

Conclusion

The small business sector of the economy is becoming increasingly dissatisfied with the current tax system. It is perceived as being too complex, structurally inequitable and inefficient, and with a bias against savings and investment. Structural tax reform is essential to provide a viable system for economic growth and development in this vital sector of the economy.

From a small business perspective, both a comprehensive income tax system and a comprehensive consumption tax based on consumed income are viable alternatives for fundamental tax reform. Both proposals offer a substantial simplification of the existing system, a great service to small business. In addition, both systems will also substantially improve equity and efficiency and increase incentives for savings and investment -- both necessary for increased small business and capital formation. While both will present short-term transition problems for small businesses, the benefits to be derived from such reform will be far greater.

Art Center College of Design 1700 Lida Street Pasadena California 91103-1999 Phone (818) 577-1700

Hearing on Tax Reform Proposals
August 6, 7, 1984

To The Honorable Robert J. Dole

and Members of the Senate Finance Committee

Art Center College of Design, Pasadena, California, is an independent, tuition and gift supported institution which receives more than $1 million each year in contributions from alumni, parents, friends, corporations and foundations. The college's financial health and growth depends, in large measure, upon its gift income from these sources. Tax deduction incentives for donors have long been part of the income tax system and have encouraged many to contribute to the welfare of private colleges, hospitals and church organizations.

May I respectfully request, on behalf of Art Center, that as you consider possible changes in the tax law structure you will preserve the integrity of tax-encouraged philanthropy. Continued incentives for gifts to our independent institutions, no matter what form the final tax revisions might take, should be protected. I urge you to keep this in mind as you deliberate the options for tax reform.

Thank you.

Donald R. Kubly
President
Art Center College of Design

July 31, 1984

Statement by

American Society of Pension Actuaries

The American Society of Pension Actuaries welcomes this opportunity to submit its statement in connection with the hearing on tax reform options conducted by the United States Senate Committee on Finance. We are a national professional society, whose 2,000 members provide actuarial, consulting and administrative services to approximately 30% of all private retirement plans.

We believe it is certainly worthwhile to explore options for major revisions to the tax system. Furthermore, to the extent income taxation is to remain a backbone of the system, we see merit in examining proposals to expand the tax base. At the same time, we see great danger that tax base expansion might involve decisions which will bring long term harm to our nation.

Our particular area of concern involves the role of the private sector in delivering retirement income security. Using the measuring techniques currently employed by the Treasury Department, the "tax expenditures" associated with the private retirement system appear monumental. Any consideration of tax base expansion is bound to bring continuation of these "tax expenditures" into question, with potential danger to the continued existence of the private retirement system.

We find the Treasury approach to measurement of the retirement plan tax expenditures quite inappropriate, because it measures pension-related costs in a cross section context. In other words, taxes deferred on pension contributions and earnings are offset against taxes paid on pension benefits by current recipients. Since current workers have higher incomes and are more likely to receive pension benefits than current retirees, current workers defer more in current taxes but will pay more in taxes on benefits in retirement. We commend you to the very excellent work done by the Employee Benefit Research Institute in this area which indicates that the real tax expenditures associated with the private retirement system are far less than the numbers provided by the Treasury Department.

The other side of the coin is the tremendous benefits the country derives from the private retirement system, retirement and other benefits to millions of our citizens and the creation of the largest single pool of investment capital available to our economy.

A recent research paper shows that, based on age in 1979, 37% of all families in the 55-64 age cohort will receive a pension benefit from an employer sponsored plan, while 71% of all families in the 25-34 age cohort will receive a benefit from an employer sponsored plan. The age cohorts between 35 and 54 show percentages between the 37% and 71% number, with the higher percentage in the lower age cohort. (These figures include Civil Service pension coverage, but this is a very minor part of the total coverage.) The implications of these numbers are obvious. The private pension system is providing retirement benefits to many millions of Americans, and the rates of receipt of pension benefits will be significantly higher in the future than they are today.

We also feel strongly that any damage done to the private retirement system will inevitably mean an expanded Social Security system. As the nation ages, the private pension system becomes even more critical. "The Graying of America" is taking place, and at a progressively faster rate. The 65-and-older population grew twice as fast as the rest of the population over the last two decades. The 1980 census showed that there were 25.5 million people over 65 years old, 28 percent more than in 1970. By 2030, one fifth of the population (64 million people) will be over age 65, according to the census bureau's projections. If the private system is permitted to decline, Social

Security will have to grow. The fiscal effect of a mushrooming Social Security system will make the current private plan tax expenditures look miniscule by comparison.

Secretary of Labor Donovan recently indicated that the assets backing private pension plans had grown from $150 billion in 1970 to nearly $900 billion today. He further indicated that they are expected to grow to $3 trillion by 1995. These funds are vital to provide the financial fuel for America's economy.

We believe there are several basic reasons for continuing the current system of tax incentives that favor the growth of the private retirement system. These are stated below.

1. Our society will continue to insist that its older citizens be permitted to live in dignity, comfort, and self-respect after retirement.

2. Individuals will not generally make their own provision for retirement through voluntary savings.

3. Even if we were starting from scratch, it would not be desirable that the whole task of providing retirement income be handled through the public sector. The public sector would not do the job with the degree of administrative efficiency likely to be achieved by private enterprise. Furthermore, the overall arrangement should make allowances for regional and cultural differences in workers' needs. Allowances for these differences would prove difficult in a totally public program.

4. The current interaction of public and private programs has experienced a significant degree of success. It would be a disorderly and costly setback to scrap this current interactive approach in favor of an all-public arrangement.

Conclusion

The rallying cry, today, is deficit reduction. This makes all tax expenditures guilty until proven innocent. We believe intelligently conceived tax expenditures, designed to encourage effective private retirement plans, will help rather than hurt the federal budget. An effective private retirement system will clear the way for a de-emphasis of Social Security. A diminution of the private pension system, by a curtailing of the tax incentives that encourage it, will lead to a very costly expansion of the Social Security system, with negative effects on the Federal budget.

aug 7 & 9

STATEMENT OF THE
AMERICAN PETROLEUM INSTITUTE
SUBMITTED TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Regarding

HEARINGS ON MAJOR TAX REFORM OPTIONS

Washington, D. C.

August 7 and 9, 1984

In response to the Committee's request for testimony concerning major tax reform the American Petroleum Institute ("API") offers the following comments concerning taxation of the petroleum industry which we feel are important in considering tax reform. Some of these comments have been made to the Committee on prior occasions.

This presentation begins with a general overview of recent trends in the profitability of the oil and gas industry, its investment in new energy resources, and the effective tax rates it faces. It then turns to a tax issue of special importance to the petroleum industry -- the broad issue of capital cost recovery. Congress has achieved significant reform in this area in recent years and it would be a step backward to tamper with the current system.

I. PETROLEUM INDUSTRY PROFITABILITY, CAPITAL EXPENDITURES, AND TAXES

A. Current Business Outlook

Oil consumption in 1983 in both the U. S. and other industrialized OECD countries has fallen about 18 percent below its peak 1978 level; and in constant dollars, current Rotterdam spot prices for Saudi Light are now about 45 percent below the heights reached during the 1979-80 oil crisis.

With falling oil demand and prices, the profits of U.S. oil companies have suffered. Among 24 major U.S. oil companies, 1983 average earnings were almost 28 percent below the peak level reached in 1980. Inflation has produced an even larger decline in real profits. Data available for 21 of the 24 companies show a profit decline of 24 percent in nominal dollars as against a drop of 70 percent in deflated dollars. The companies' return on investment, which typically has been about the same as that for industry generally, has dropped much faster than profits since the historical peak in 1980. More detail is provided in Appendix A. Investors are concerned that past expenditures made by oil companies in anticipation of high and rising prices are likely to be unprofitable as a result of possible further erosion of demand and price decline. Indeed, many high-risk energy ventures have already been abandoned.

Oil companies are reassessing and often reducing the scope of their operations. For the first time since the early 1970's, the total worldwide capital expenditures of leading U. S. oil companies turned down in 1982 and again in 1983. In addition, capital outlays on oil exploration, development and production turned down in 1982 and 1983. Even after the down turn, expenditures in 1983 were almost six times the 1968 spending level in current dollars. While expenditures in 1984 are expected to exceed the 1983 level, the rate of increase is not likely to be great for the remainder of the decade unless investment prospects appreciably improve. The reduced activity in the domestic oil industry is illustrated by an active rig count which decreased from 4,500 in December, 1980 to 2,415 in July, 1984, a decrease of 46.3 percent.

Expectations of risk-adjusted increased profitability provide the incentive for growth in oil industry capital spending, through dedication of oil companies' cash flow and recourse to capital markets. As Appendix B shows, capital expenditures move closely with profits, but there is a lag because of commitments already made on projects having relatively long lead times.

B. Current Taxes

In the face of receding demand, the taxes paid by oil companies have remained high. Total Crude Oil Windfall Profit

Tax ("WPT") collections in the United States increased from $10 billion in 1980 to about $26 billion in 1981 and then, with falling crude oil prices, declined to $17 billion in 1982 and to a $12 billion annual rate in the first half of 1983. In combination with other federal and state taxes on oil output and income, the effect of the WPT has been to strip about 80 cents of each additional dollar of oil company revenue due to U.S. oil price decontrol.

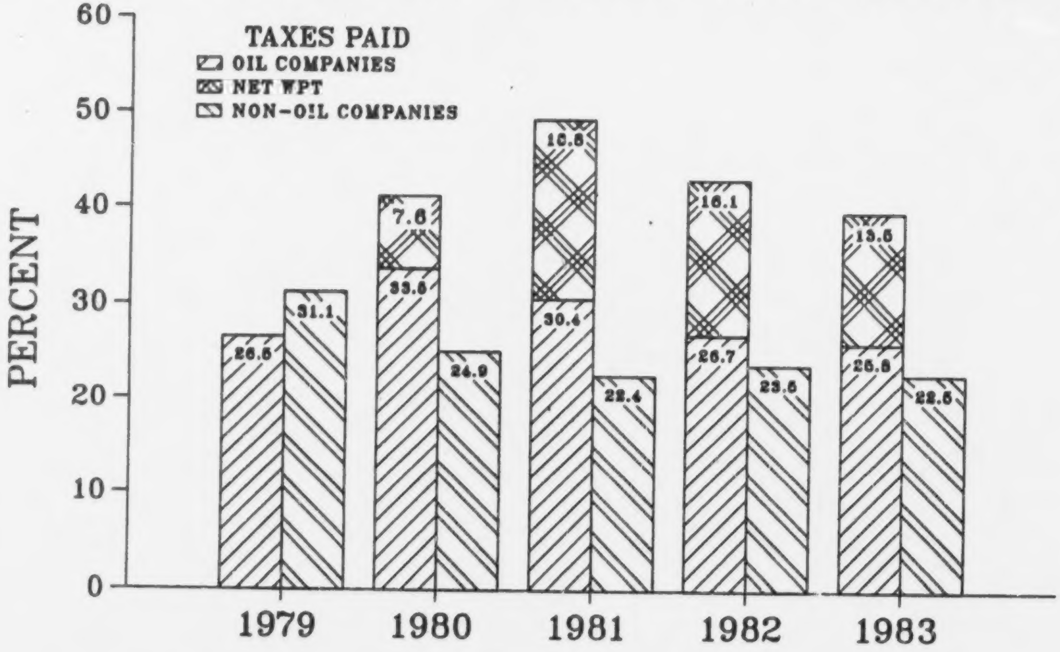
The WPT properly should be considered a part of the oil industry's federal tax burden even though it is an excise tax. Since a similar levy is not imposed on the price of foreign oil which competes with U.S. oil, U.S. producers are unable to pass the WPT on in higher prices. Inasmuch as the WPT is imposed directly on a portion of crude oil revenues, excluding consideration of the tax would significantly distort the industry's tax burden relative to that of all other industries which are not subject to such a tax.

Combined U.S. current federal income tax and WPT liabilities incurred by 24 leading oil companies grew to $23 billion in 1981 from $14 billion in 1980, before falling back to $15 billion in 1982 and $11 billion in 1983. Because U.S. income before these taxes rose at a slower rate, the oil companies' effective U.S. federal tax rate (current federal income taxes plus the WPT divided by income before such taxes) increased from 26 percent in 1979 to 41 percent in 1980, 49 percent in 1981 and then declined to 43 percent in 1982 and 39.3 percent in 1983. These tax rates have been significantly higher for oil companies than for non-oil companies each year in the 1980-83 period. These data do not reflect the practice of state and local governments of taxing U.S. oil producers more heavily than other kinds of companies. In particular, these figures exclude the billions of dollars of severance taxes and property taxes on oil and gas reserves paid by U.S. oil producers. In 1983, domestic taxes incurred by 24 leading oil companies totaled $30.2 billion. This includes $10.1 billion of motor fuel and other product excise taxes and over $20 billion of current U.S. federal, state and local income taxes.

Chart I compares the federal tax burden of leading U.S. oil and non-oil companies for 1979 through 1983. The oil industry graphs display two factors: the combined Windfall Profit Tax and current U.S. federal income tax burden as well as the estimated level of petroleum industry federal income tax had the Windfall Profit Tax not been enacted. Deferred federal income taxes (which arise primarily from the difference between tax and financial book cost recovery) are excluded. Deferred income taxes are highest for industries, such as petroleum, which are investing heavily in new plant and equipment. As the chart indicates, in 1983 the current federal tax burden for the leading petroleum companies was 39.3 percent compared to 22.5 percent for leading non-oil companies.

CHART I

COMPARATIVE FEDERAL TAX BURDEN OF LEADING U.S. OIL AND NON-OIL INDUSTRIAL COMPANIES



Source: American Petroleum Institute

Note: 24 Oil and 100 Non-oil Companies. Oil income taxes shown for 1980-1983 are what would have been paid without the Windfall Profit Tax, which is shown net of the income tax offset. In the WPT computation procedure, the WPT is deducted from income, and income tax is levied on the residual. If there were no WPT, the income tax would be higher--as shown above. WPT is not shown for non-oil

Studies by the staff of the Joint Committee on Taxation, which do not include payment of WPT, revealed that 24 leading petroleum corporations paid 18.2 percent of their pre-tax U.S. income in federal income tax for 1982, while the average for all corporations for 1982 was 16.1 percent. Results for 1980 showed the effective income tax rate for petroleum companies was 31.1 percent, compared to 21.8 percent for all corporations. The 1981 rates were 21.7 percent for petroleum companies and 17.2 percent for corporations as a whole.

A study of the taxes paid by large domestic petroleum companies for 1974-1982 completed by the Petroleum Industry Research Foundation, Inc. in March 1984 confirmed that the petroleum industry has carried a heavy tax burden. For 1980-1982, the large petroleum companies paid federal income taxes at a three-year average rate of 26 percent compared to an average rate of 16 percent for the nearly 200 large non-oil companies included in the Joint Committee on Taxation's study.

Other studies have analyzed the impact of U.S. taxes on the incentive to invest and have concluded that major oil companies face higher prospective U.S. taxes than most other investors. In a report published by Harvard's Energy and Environmental Policy Center, in June, 1984, Robert C. Fry, Jr. found that the effective marginal tax rate, adjusted for industry-specific taxes and tax provisions, for major oil companies is 20 percent higher than the average marginal rates across all U.S.

industry. Fry attributes this to the Windfall Profits Tax, the loss of the percentage depletion allowance for integrated oil companies, the impairment of the deduction for intangible drilling and development costs, and the state and local severance and excise tax burden of the industry. The Fry report states that any move to further reduce the proportion of exploration and development expenditures which can be expensed or to extend the Windfall Profits Tax will have a negative impact on future oil and gas development.[1]

Even though the oil industry's tax burden is among the highest in the country, some have suggested additional levies on oil producers. New or increased taxes would further reduce returns on investment and sources of funds to an industry already hurt by declining demand and prices. As a result, oil companies would find it less attractive to find and develop new energy supplies. Such a reduction would jeopardize the progress made in recent years to reduce the world's dependence on OPEC oil.

While oil demand has dropped sharply in recent years and may continue to drop in the years ahead, it is dangerously premature to conclude that U.S energy problems have ended. Imports still account for almost one-third of U.S. crude oil requirements. The success that oil companies have had in reversing the decline in U.S. oil production and diversifying oil supplies worldwide ought not to be undone through the imposition of new taxes. The advantage of hindsight makes it clear that the U.S. energy crisis of the 1970's could have been resolved at far lower economic and political cost if only U.S. oil prices had been decontrolled earlier and U.S. oil producers had been taxed less.

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[1] Fry, Robert C., Jr., Industry-Specific Taxes and Effective Tax Rates, John F. Kennedy School of Government, Report No. E-84-05, Harvard University, Cambridge, Massachusetts, June, 1984.

Private investment, responding to relative rates of return, is the most effective method of allocating capital resources throughout the economy. Interference with this process diminishes the economy's efficiency. Thus, taxing petroleum even more than other industries hurts the efficiency of the economy and the prospects for a strong recovery. Furthermore, it would discourage energy investment just as the country is making encouraging progress in the quest for energy security.

II. CAPITAL COST RECOVERY AND INVESTMENT INCENTIVES

A. In General

The oil industry is particularly concerned about recent proposals to modify substantially the current system of capital cost recovery and investment in incentives. For example, the "Fair Tax Act" introduced by Senator Bradley and Representative Gephardt proposes repeal of the investment tax credit, repeal of current expensing for intangible drilling and development costs (IDC), and introduction of an open-ended 250 percent declining balance method of capital cost recovery which would significantly lengthen the present three- and five-year recovery periods for new investment in plant and equipment. It suggests a nominal 10-year period for petroleum exploration and production investment (upstream) and 18 years for refineries (downstream). Note that full capital recovery would not be achieved under this proposal, and there is no allowance for inflation. A system permitting the full pre-tax recovery of real capital costs is crucial to a healthy investment climate.

The capital cost recovery system relevant to most investment in the United States has been studied and improved over a number of years to move toward the goals of full recovery, simplicity, and economic efficiency. Its modernization began with the adoption of accelerated recovery methods in the 1954 Code. Recovery lives were reduced and recovery enhanced during the Kennedy Administration with the adoption of Guideline Depreciation. The adoption of Asset Depreciation Range (ADR) in 1971 and the Accelerated Cost Recovery System (ACRS) in 1981 further improved the system. It would be unfortunate to reverse this favorable trend and sacrifice future economic growth to obtain what at best may be only a temporary revenue gain.

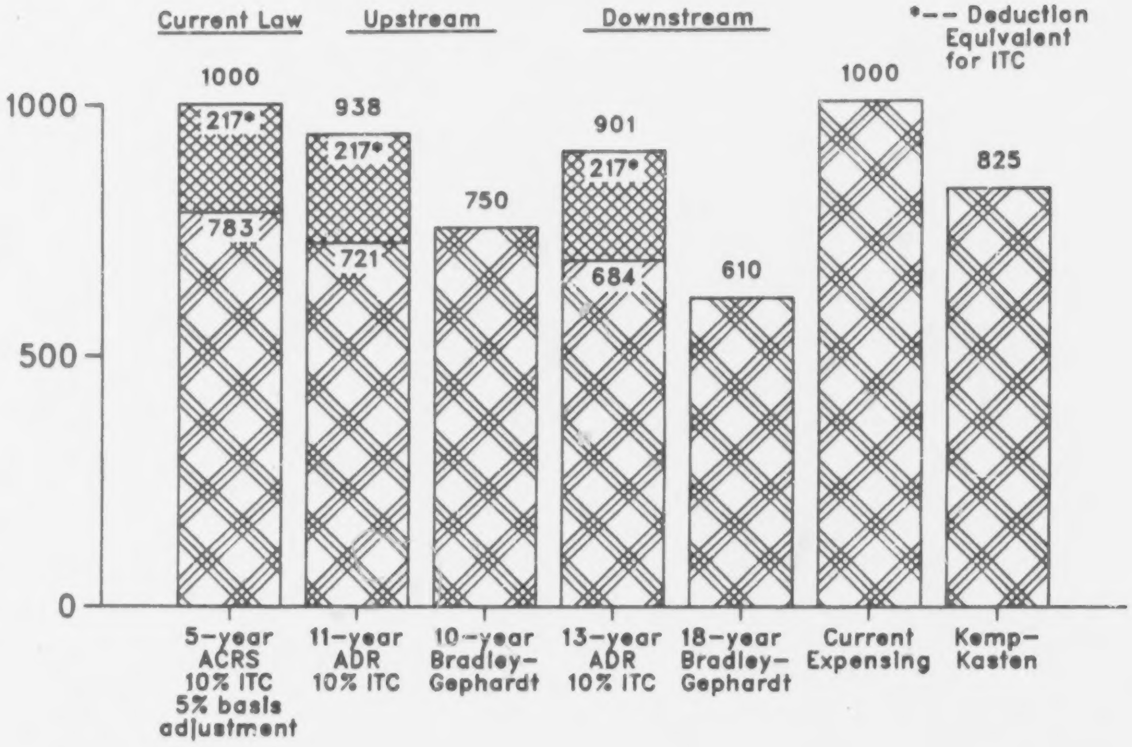
Also during the Kennedy Administration, the Investment Tax Credit (ITC) was introduced as an incentive for investment. Its presence in the Internal Revenue Code helps offset the effects of inflation on depreciation allowances based on historical costs.

The ITC also helps offset the inherent bias of the income tax against savings and investment. The traditional income tax is biased against savings and in favor of consumption in that it, in effect, taxes savings twice: once when the income from which savings are generated is earned and again when the proceeds of savings are realized. If real capital costs are not fully recoverable, a third tier of tax -- a tax on the capital, itself -- would be levied on all capital investment. This bias against savings and investment is exacerbated by the corporate income tax, which imposes a fourth tier of tax on investment income in corporate form.

ACRS and current expensing are the two capital recovery systems which Congress considered in 1981, with ACRS adopted.

CHART II

Present Value of Various Cost Recovery Allowances and Investment Tax Credit (ITC) for $1,000 of Investment Discounted at 10% –– Assuming No Inflation



Current law with five-year ACRS plus an investment tax credit of eight percent (without basis adjustment) is roughly comparable in present value to current expensing of capital investments at a real discount rate of 10 percent (with no ITC). At higher discount rates -- as would be appropriate with inflation -- the present system of ACRS plus ITC falls short of current expense equivalency.

For upstream petroleum investment, Bradley-Gephardt would result in a present value of future capital cost recovery allowances of only about 75 percent of the present value of either five-year ACRS (plus the ITC) or current expensing -- assuming a 10 percent real discount rate and zero inflation. (See Chart II.) Thus Bradley-Gephardt would be a step back from either system. Bradley-Gephardt would reduce the present value of capital cost recovery to only 61 percent of the value of ACRS (plus the ITC) for recovery of new investment in the refining facilities necessary to meet future requirements for lead-free gasoline production.

The "Fair and Simple Tax Act" proposal introduced by Senator Kasten and Representative Kemp also proposes repeal of the investment tax credit and current expensing of intangible drilling and development costs. Even though it would retain ACRS, the Kemp-Kasten repeal of ITC would result in a present value of capital cost recovery for new investment of about 83 percent of either ACRS (plus the ITC) or current expense equivalency -- assuming a 10 percent discount rate with zero inflation.

Any capital cost recovery sytem should be designed to neutralize the effects of inflation on the recovery of real capital costs. The eroding impact of inflation on recovery of capital costs would be exacerbated by lengthening depreciable lives. Moreover, reduction or elimination of the investment tax credit would diminish or eliminate the inflation offset provided by that provision. The longer it takes to recover capital costs, the smaller the real value of the recovery. Long recovery periods may result in recovery of less than the full real value of the capital invesment, even if the investment tax credit were (improperly) counted as part of capital recovery rather than as an investment incentive.

For example, with a CBO-projected annual inflation rate of five percent, the present capital cost recovery system for assets in the five year ACRS category would require an effective investment tax credit of at least 11.4 percent (without basis adjustment) to achieve the incentive effect of current expensing. (See Chart III.) Present law provides only an eight percent ITC without basis adjustment.

In addition to ameliorating the effects of inflation, the current capital cost recovery system is a major advance

CHART III

A COMPARISON OF ACRS PLUS ITC WITH CURRENT EXPENSING1)

UNDER NO INFLATION AND 5% ANNUAL INFLATION

No Inflation:

Year	Actual Value	Discount Factor P.V. @ 10%	Present Value	
1 ACRS Allowance	150	1.0000	150	
2 ACRS Allowance	220	.9091	200	
3 ACRS Allowance	210	.8264	174	
4 ACRS Allowance	210	.7513	158	
5 ACRS Allowance	210	.6830	143	
TOTAL ACRS ALLOWANCE	$1,000		$825	
Incremental Deduction necessary to maintain current expense equivalency2)			$175	
ITC rate (without basis adjustment) necessary to match the incremental deduction at a 46% tax rate3)				8.1%

5% Inflation:

Year	Present Value	Discount Factor P.V. @ 15.5%4)	Present Value	
1 ACRS Allowance	150	1.0000	150	
2 ACRS Allowance	220	.8658	191	
3 ACRS Allowance	210	.7496	157	
4 ACRS Allowance	210	.6490	136	
5 ACRS Allowance	210	.5619	118	
TOTAL ACRS ALLOWANCE	$1,000		$752	
Incremental Deduction necessary to maintain current expense equivalency2)			$248	
ITC rate (without basis adjustment) necessary to match the incremental deduction at a 46% tax rate3)				11.4%

---

1) At a 10% real discount rate

2) Calculated as difference between $1,000 and present value of total ACRS allowance.

3) $\dfrac{\$\ \text{Incremental Deduction X } 46\%}{\$1,000}$

4)

(1.10)	X	(1.05)	=	1.155
Real		Inflation		Nominal
Real		Rate		Rate
10%		5%		15.5%

toward the goal of simplicity. The Accelerated Cost Recovery System categoriezes most annual capital investments in machinery, equipment, and special purpose structures into two recovery period classes (three and five years). There are also only two periods for structures (10 and 18 years). Short of expensing capital investment in the year incurred, it is difficult to visualize a notably simpler system of cost recovery that would at least partly protect recovery from inflation. Current expensing would, of course, fully protect the taxpayer's recovery of capital costs from the effect of inflation and would be the simplest system to administer.

B. Intangible Drilling and Development Costs

IDC's are costs incurred for items which, in themselves, have no salvage value and are "incidental to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas." Treas. Reg. 1.612-4(a). Such costs expressly include wages, fuel, repairs, hauling, supplies, etc., which are incurred in the drilling of wells, in the clearing of ground, and in the construction of derricks, tanks and other physical structures that are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

For income tax purposes, IDC's are capital in nature and, as such, would ordinarily be taken into account through 5 year ACRS and be eligible for the 10 percent investment tax credit. Under section 263(c) of the Internal Revenue Code and Treasury Regulations promulgated thereunder, taxpayers are permitted to deduct currently IDC's for oil and gas wells and wells drilled for geothermal deposits. Only the holder of a "working" or an "operating" interst (i.e., the interest which is burdened with the risks and costs of developing and operating the property) may currently deduct IDC's. Moreover, the election to deduct IDC's must be made by the taxpayer for the first taxable year in which such costs are incurred and is binding for all subsequent years. At the same time, the costs of all tangible equipment used in drilling and development activities are capitalized and recovered through 5 year ACRS with ITC.

Section 291(b), which was added to the Internal Revenue Code by the Tax Equity and Fiscal Responsibility Act of 1982, reduced the amount of current IDC deductions by 15 percent for all corporations that are integrated oil companies. The 15 percent is allowed as a deduction ratably over a 36-month period, beginning with the month in which the costs are paid or incurred. Sec. 291(b)(2)(A). These amounts are not eligible for investment tax credit and are also subject to recapture on later disposition of the property under Sec. 1254. During consideration of this change the Senate Finance Committee adopted and the full Senate approved recovery of the 15 percent reduction in expensed IDC's using the five year ACRS schedule with the ITC, beginning in the year the property was placed in service. This is the same treatment afforded tangible well equipment and intangible costs such as transportation, labor, etc. involved in the acquisition and installation of other machinery and equipment or in the drilling of water wells for irrigation, etc. Although this rule was not adopted in the final version of TEFRA, its propriety is recognized by the election granted individuals to use five year ACRS with ITC. The Deficit Reduction Act of 1984 reduced the amount of current IDC deductions to 80 percent for corporations that are integrated oil companies. The remaining 20 percent is allowed as a deduction ratably over a 36-month period.

Corporations which are nonintegrated oil companies are allowed to deduct currently 100 percent of their IDC expenditures. Similarly, all individuals are allowed to elect to deduct currently 100 percent of their IDC expenditures. However, if an individual elects to deduct the full amount, he must include the amount of "excess intangible drilling and development cost" in determining tax preferences for purposes of the alternative minimum tax. Treatment as a preference item can be avoided if the individual elects to deduct the costs under a five-year schedule similar to ACRS and claim ITC under Sec. 58(i)(4); or ratably over a ten-year period under Sec. 58(i)(1).

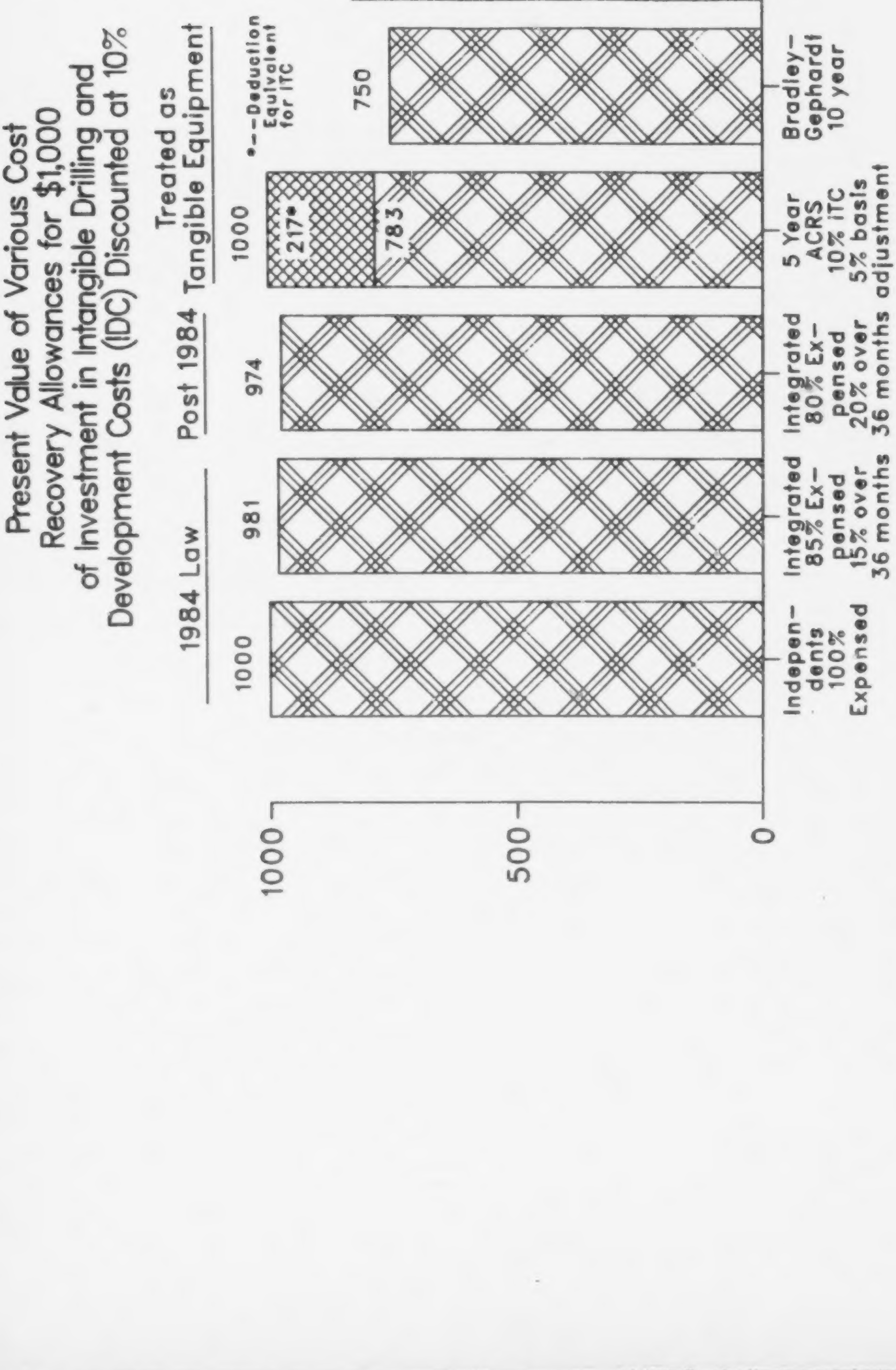
The following chart summarizes the current tax treatment of IDC's:

Corporations which are integrated oil companies	Corporations which are independent producers	Individuals
o Currently deduct 85 percent of IDC's: 80 percent after 1984. o Amortize 15 percent over 36 months--no ITC; 20 percent after 1984.	o Currently deduct 100 percent of IDC's	o Currently deduct 100 percent of IDC's o Tax preference item if currently deducted o May elect five-year ACRS with ITC if not a limited partnership interest. o May elect ten-year amortization

The tax treatment of IDC's was an outgrowth of the fact that many taxpayers considered the expensing of such costs to be an acceptable accounting practice. The treatment was also justified as a means of encouraging the exploration and development of our nation's oil and gas resources. The policy to develop domestic oil and gas resources still supports the need for rapid recovery of IDC's for tax purposes. Indeed, financial risks have escalated as the industry must more frequently drill in high-cost, hostile offshore and frontier environments.

Thus, the current deduction for IDC's substantially improves the financial attractiveness of oil and gas exploration and production relative to recovery over a longer period of time. Chart IV reveals that the recovery of IDC's under Bradley-Gephardt is less favorable than under either Kemp-Kasten or current law. Costs recovered in the present are less burdensome

CHART IV


Present Value of Various Cost Recovery Allowances for $1,000 of Investment in Intangible Drilling and Development Costs (IDC) Discounted at 10%
1984 Law
Post 1984
Treated as Tangible Equipment
*--Deduction Equivalent for ITC
1000
500
0
1000
981
974
1000
217*
783
750
825
Indepen- dents 100% Expensed
Integrated 85% Ex- pensed 15% over 36 months
Integrated 80% Ex- pensed 20% over 36 months
5 Year ACRS 10% ITC 5% basis adjustment
Bradley- Gephardt 10 year
Kemp- Kasten

than costs recovered in the future, especially in a period of high inflation or interest rates. Moreover, many members of the industry, both large and small, do not readily have the cash resources or borrowing ability to absorb the additional costs which would be caused by deferring deduction of drilling expenditures. For many taxpayers, the immediate cash flow generated by the IDC deduction can be an absolute prerequisite to participation in the industry.

Current deduction of IDC expenditures has been a part of oil and gas tax law since the inception of the income tax. Its importance is widely recognized as it helps to attract investment into oil and gas development despite the high financial risks and costs. Oil and gas wells are expensive and have rapidly become more so as the search for new supplies has extended into harsher environments and farther offshore in greater water depths. Only about one in five wildcat wells find oil in commercial quantities and many of those fail to cover their total costs. Numerous dry holes are encountered even in drilling operations in areas where oil and gas reserves are known to exist.

We would now like to review for the Committee the current status of the deduction for depletion and reiterate that cost depletion is an inadequate cost recovery mechanism.

C. Depletion

The Tax Reduction Act of 1975 added Sec. 613A of the Internal Revenue Code to eliminate percentage depletion on oil and gas production. Certain exemptions were provided, however, including a limited exemption for independent producers and royalty owners. API believes that percentage depletion was and remains an effective replacement cost recovery mechanism which encourages exploration and production of oil and gas by recognizing the high risks and the enormous capital outlays required to replace reserves today in the industry.

Depletion is a capital recovery mechanism. An owner of an interest in an oil, gas or mineral property incurs costs which, for tax purposes, are considered capital in nature. These include acquisition costs, such as lease bonuses, which are capital for financial and tax purposes and certain other costs, such as geologic and geophysical exploration costs, which are considered an expense item by accounting standards but are capitalized for tax purposes.

This capital must be recovered by "cost" depletion if percentage depletion is unavailable. Cost depletion is typically taken by the unit-of-production method -- which limits current capital cost recovery to an estimate of how much of the property's total remaining output is represented by current production. Thus, when a barrel of oil is produced, it is ratioed with remaining reserves and multiplied by the adjusted tax basis of the property involved to determine the amount of the current depletion deduction. For a long-lived property, this method of recoupment is the slowest method of capital recovery available under current law. Real costs of capital invested have thus been "under-recovered" in recent years primarily due to the effects of inflation. By contrast, ACRS investors in manufacturing plant and equipment are able to recoup their investment within a minimum of five years after operation begins, even if the expected productive life of the investment is longer.

Congress first adopted percentage depletion in 1926 as a replacement for "discovery value depletion". Percentage depletion is designed to encourage drilling activity and to approximate the cost of replacing reserves currently produced. Depletion calculated on the percentage method allows the owner of the oil or other wasting natural resource to recover a percentage of gross income subject to certain limitations. In the case of oil and gas, the current rate of percentage depletion is 15 percent; which is substantially below the current value of reserves in the ground as a percentage of wellhead price (about 25 percent by some estimates).

Many of the underlying reasons for enacting percentage depletion initially, i.e. high risk and high cost, justify its continuation today. Risks remain high: the industry experienced dry holes on over 80% of all wildcat wells drilled. Furthermore, costs per barrel of new reserves have risen dramatically. Finally, and perhaps most importantly, in the past several years domestic consumption has exceeded domestic reserve additions.

The elimination of percentage depletion on oil and gas production of integrated oil companies in 1975 was, in part, a political reaction to the dramatic increases in oil prices that occurred after the Arab oil embargo. The retention of percentage depletion on certain limited production for eligible producers enables such operators to obtain the risk capital necessary to drill prospects which have been made uneconomic for non-eligible producers due to the removal of percentage depletion. The marginal prospect remains important in the outlook for potential additions to domestic reserves.

U. S. proved reserves steadily declined from 1970 through 1980 despite increased oil prices and record capital outlays by the oil and gas industry. Over the same period, the cost of replacing reserves rose dramatically. Inflation, which affects all business, contributed to the increase in geological and geophysical costs. Also, potential reserve additions were located in deeper zones or in otherwise more operationally difficult, and hence expensive, areas like deep offshore waters, the Alaskan Arctic, etc. Finding costs escalated as wells were drilled deeper, the cost per foot drilled increased and reserves discovered per well drilled became smaller. While the rate of the increase in these costs has slowed, and indeed some of the costs have actually declined since the 1981 peak, the use of historical cost as a base for computing depletion simply fails to take into account the true cost of replacing existing reserves, especially when costs have increased as they have in the last decade. The income generated by the sale of production from these reserves represents the consumption of a nonrenewable capital asset. As such, it is reasonable to consider the cost of replacing the reserves as the base on which recovery should be computed, rather than historical cost.

Rising prices through 1980 encouraged the oil and gas driller in finding oil and gas. Undoubtedly, however, some wells were not drilled and some production was forfeited by the removal of percentage depletion for integrated oil companies. In today's market, however, the demand for oil and gas products has declined, resulting in a corresponding decrease in price. Percentage depletion ameliorates the effect of this decline to some extent for independent producers. API believes that percentage depletion was and remains an effective replacement cost recovery mechanism which encourages the production of oil and gas.

III. CONCLUSION

Under current law, the oil industry's tax burden is among the highest in the country. New or increased taxes would further reduce returns on investment and sources of funds to an industry already hurt by declining demand and prices. Furthermore it would discourage energy investment just as the country is making encouraging progress in the quest for energy security.

The current capital cost recovery system, relevant to most investment in the U.S., which includes Accelerated Cost Recovery and the Investment Tax Credit, is not in need of reform. It permits taxpayers to recover real, not nominal, capital costs. In addition, it achieves the goal of simplicity.

APPENDIX A

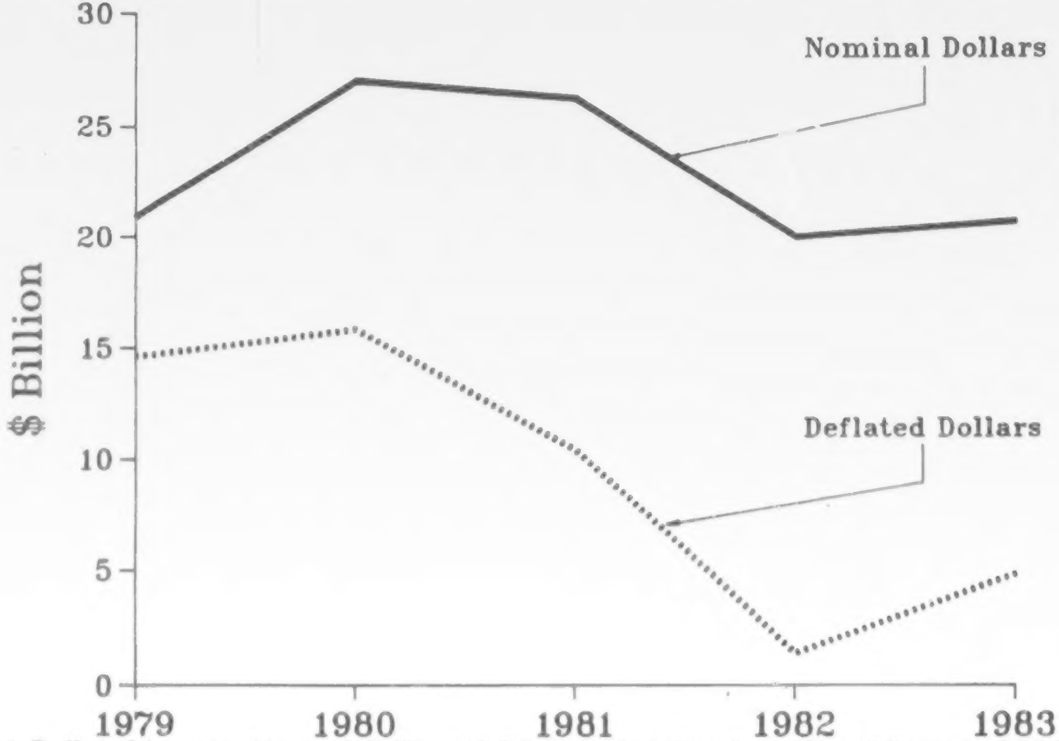
Petroleum Profitability

Chart V shows worldwide profits of leading U. S. oil companies for the period 1968-1983 in both current and constant dollars. When the real buying power of a profit dollar is considered, the 1983 profit figure of more than $21 billion is equivalent to $4.8 billion after adjustment for replacement costs (FASB current cost method).

To compare profits in the oil industry with profits of other industries we must adjust profits for the size of the industry. Rate of return on investment permits us to do this. Chart VI shows that return on investment in the oil industry has been about the same as that for other manufacturing companies. Real return on investment has declined sharply as a result of inflation. Chart VII details the nominal and constant dollar return on investment of 21 leading U.S. oil companies.

CHART V

Worldwide Profits of 21 Leading Oil Companies In Reported Nominal and Deflated Dollars*

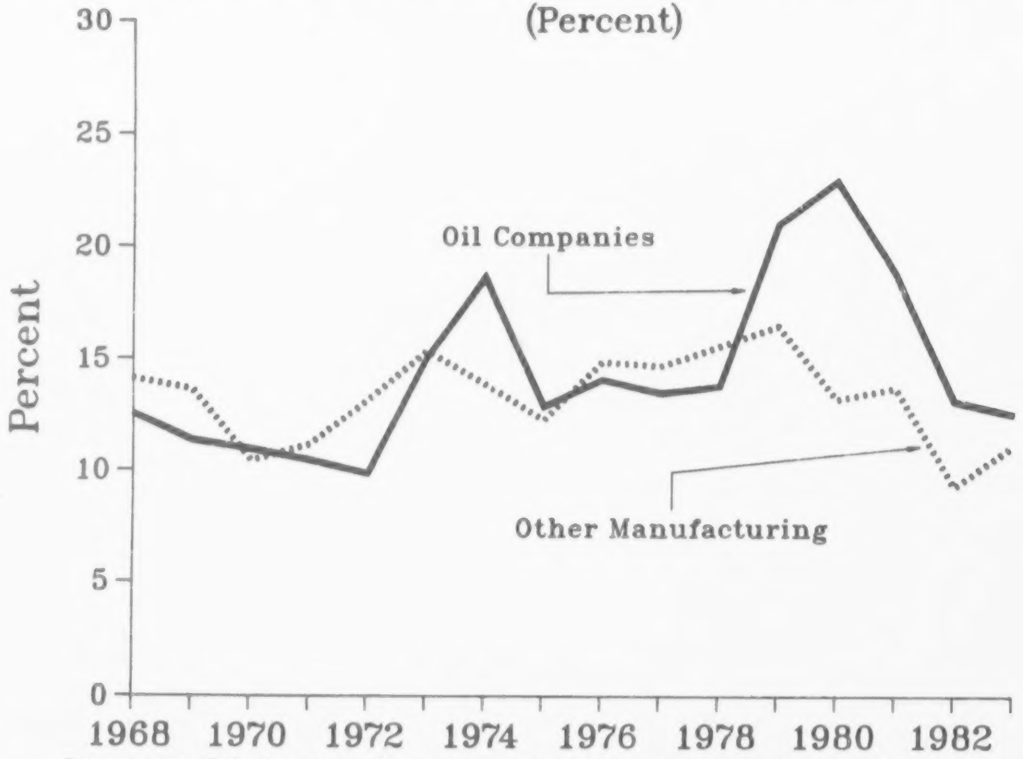


* Deflated in accordance with Financial Accounting Standards Board Current Cost Methods. (Replacement costs in average 1983 dollars, CPI-U, 1967=100)

CHART VI

Worldwide Return on Average Shareholders Equity 24 Leading U.S. Oil Companies vs. Other Manufacturing

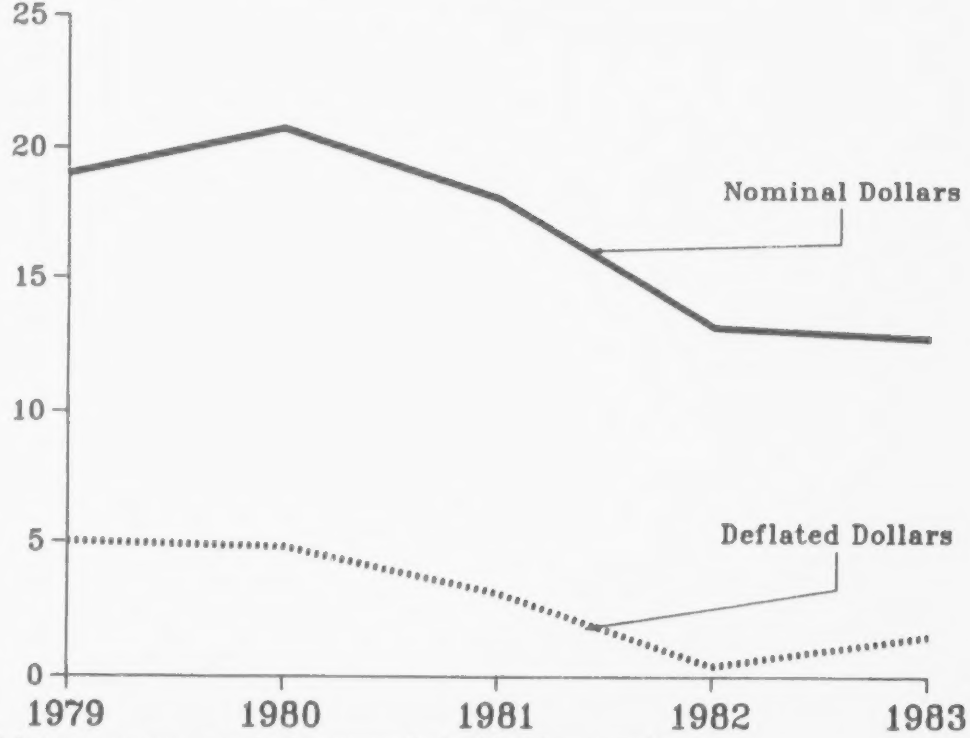
(Percent)



Sources: Oil Companies--American Petroleum Institute
Other Manufacturing--Standard and Poor's Compustat Services

CHART VII

Worldwide Reported Return on Investment of 21 Leading U.S. Oil Companies In Nominal and Deflated Dollars*



* Net income as a percent of year-end stockholders' equity
Deflated in accordance with Financial Accounting Standards Board Current Cost Methods.
(Replacement costs in average 1983 dollars, CPI--U, 1967=100)

APPENDIX B

Distribution of Capital Expenditures

That oil companies do commit their earnings, supplemented by borrowings, to capital expenditures is shown in Chart VIII. While profits were about constant during 1968-1972, capital expenditures were also constant. Beginning in 1974, petroleum investment more than doubled, reflecting higher profits.

By 1980-81, profits were up by another $16 billion and capital expenditures were up by $26 billion. The larger absolute increase in capital expenditures was made possible by rising profits and return on investment. During 1982, capital expenditures were still $3 billion above the 1980-81 average even though profits were almost $8 billion lower, attributable to the lag resulting from investment in long lead time projects. Although profits rose marginally in 1983, capital expenditures fell by almost $9 billion, reflecting the continuing decline in return on investment and uncertainties regarding future prices and public policies.

The long-term growth of capital expenditures, noted above, as Chart IX illustrates, were primarily for petroleum and other energy sources. The spending has especially stimulated new oil production in non-OPEC countries. Production of crude oil has even been increased somewhat in the United States in 1982 and 1983, after a decade-long downward trend.

200/08

CHART VIII

Worldwide Profits and Capital Expenditures of 24 Leading U.S. Oil Companies

($ Billion)

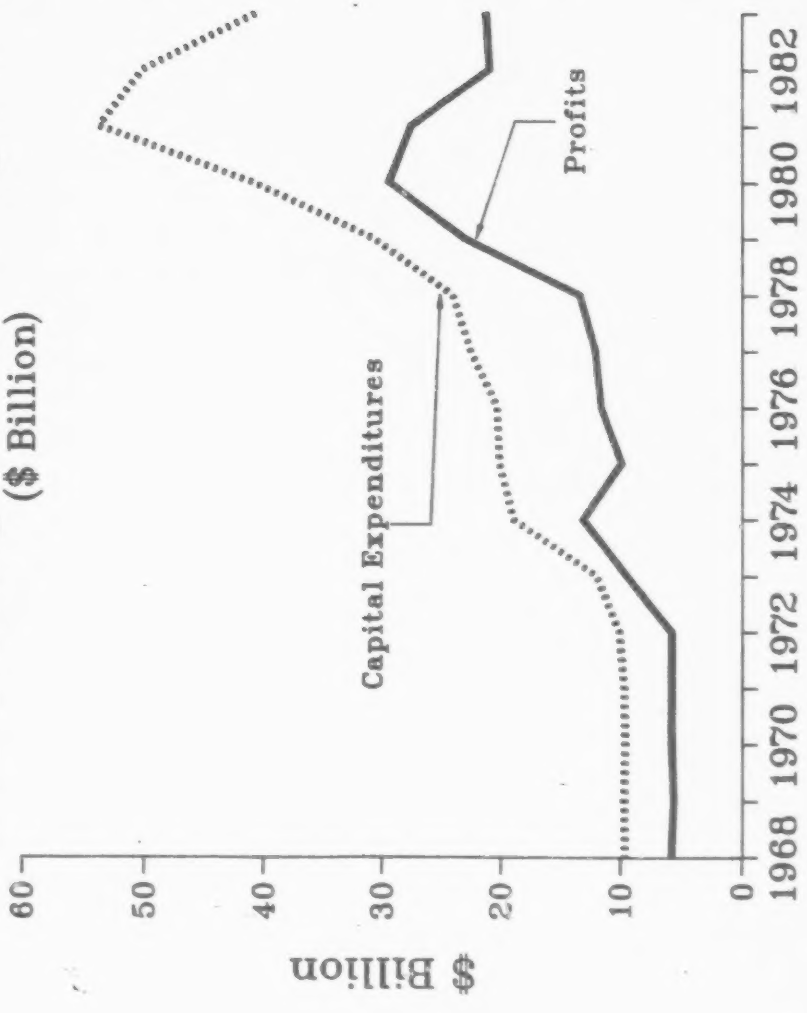
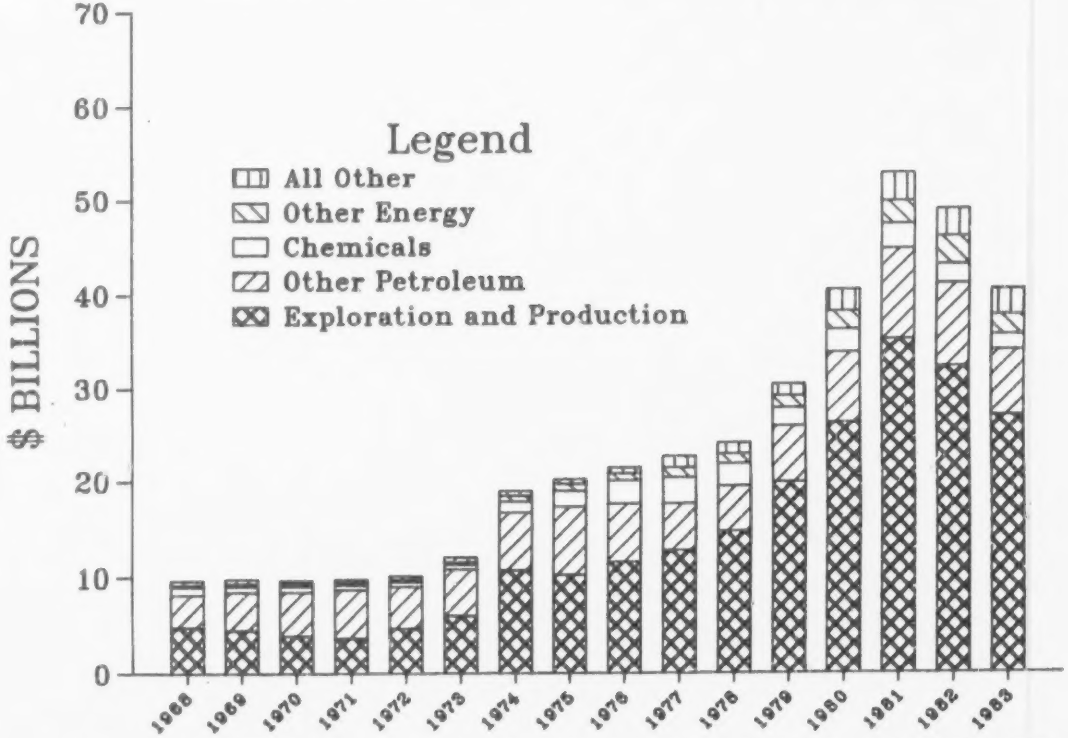


CHART IX

WORLDWIDE ADDITIONS TO PROPERTY, PLANT AND EQUIPMENT OF 26 U.S. OIL COMPANIES



Source: Energy Information Administration, U.S. Department of Energy

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414 Graham Avenue, Winnipeg, Manitoba, R3C 2R3, Canada
27 Camden Road, London, NW1 9LN, England
21, Avenue de Sainte-Marie, 94160 Saint-Mandé, France
Box 870, Auckland, New Zealand
Incorporated — a non-profit organization

338-0500 area code 612

Billy Graham EVANGELISTIC ASSOCIATION

1300 Harmon Place, Minneapolis, Minnesota 55403 U.S.A.

August 1, 1984

Roderick A. DeArment, Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

RE: Options for major revision of the tax system
August 7, 1984 and August 9, 1984 Hearings

Dear Sir:

This letter is in regard to recent tax proposals currently under review by the Senate Finance Committee. Regardless of how the tax laws may change, it is the position of Billy Graham Evangelistic Association that tax incentives for charitable giving should continue to exist.

As a tax-exempt, nonprofit organization, Billy Graham Evangelistic Association has relied in large part upon the charitable gifts of concerned individuals. We hope that these donors will retain their tax benefits so that Billy Graham Evangelistic Association may continue to provide help and assistance to needy individuals as it has in the past.

Thank you for giving serious consideration to the above comments.

Sincerely,

George M. Wilson
Executive Vice President

GMW/sdj

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Listen to "The Hour of Decision" each Sunday on Radio

DOUGLAS B. BROCKHOUSE
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August 3, 1984

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, DC 20510

Re: Finance Committee Hearings on Tax Reform Options scheduled for August 7 & 9, 1984

Dear Mr. DeArment:

I have a proposal to simplify the tax return filing process without upsetting the present impact which taxes have upon the economy. My proposal is to use the present statistical ban contained in the computor banks of the Internal Revenue Service and the Commerce Department files to prepare "safe harbor" percentages.

Under this system, each type of business would be classified (similar to the present business classifications used in connection with catagorizing return information). Based upon available statistical data for each business, an exclusion percentage would be determined. Then, to determine the taxable income derived from a particular business venture, the taxpayer would apply the applicable exclusion percentage to the gross income from the venture, and the residue would be the taxable income. For example, if based upon available statistics, it is determined that the average grocery store operation spends 97¢ of every dollar of income in cost of goods sold and operating expenses, then the applicable exclusion ratio would be 97% and the taxpayer would include in income 3% of gross receipts. The statistical base could also be applied to real estate operations, mining ventures, and certain itemized deductions.

Under the proposal, taxpayers would still be allowed to use specific deductions instead of "safe harbor" allowances, but with the following restrictions:

(a) Prior approval from the Service would have to be obtained;
(b) Until approval is obtained, taxes would have to be paid under the safe harbor pproach;
(c) Detailed records would have to be kept;
(d) Taxpayers so electing would be subject to full audit of all business records; and
(e) On audit, any improperly claimed deductions would subject the taxpayer to automatic penalty unless the proposed deduction had been disclosed fully to the Service prior to or commensurate with the filing of the return in question.

Some of the advantages of such a system are as follows:

1. Completion of tax returns are simplified for 90% of the returns presently being filed.

2. Businesses of similar nature pay a similar percentage of gross receipts in taxes.

3. In most cases, audit time is drastically reduced since inspection of records will focus on "gross receipts".

4. The revenue to be received by the Government should not be drastically affected, since present percentages will be applied.

5. Computor inspection of tax returns will be easier since there will be fewer line items to check.

6. The borrowing of money will not generate any tax advantage, but there will still be allowances for those who are required to borrow funds.

7. More efficient taxpayers will receive a tax benefit. Savings would be encouraged.

8. The new system could be employed with only a mild change in the present laws governing taxation.

The new system would have the following disadvantages:

1. the applicable exclusion percentages would have to be periodically upgraded to avoid market place distortions.

2. Taxpayers may realize a tax benefit even though they do not incur the expenses to which the benefit relates.

3. Initially, there may be some confusion over how returns are to be filed under the new system.

4. Some business distortion would occur as taxpayers reshuffle priorities in response to the lessening of the impact from taxes.

5. The use of the Tax Code to accomplish social reform would be reduced.

6. There would be some additional expense in preparing the applicable business classifications and exclusion percentages.

A careful weighing of the advantages and disadvantages listed above, clearly indicates that the above proposal of creating "safe harbor exclusion amounts" has merit and should be given careful consideration.

It is one method of simplifying the procedures for filing returns without imposing an entirely new method of taxation. Any reform is difficult, but a drastic reform is impossible. My proposal has the benefits of simplicity and reasonable fairness.

Sincerely,

Doug B. Brockhouse

Douglas B. Brockhouse

DBB:rlb

August 9, 1984

Robert L. Lighthizer, Chief Counsel
Committee on Finance
Room 2227, Dirksen Senate Office Bldg.
Washington, D.C. 20510

WRITTEN STATEMENT BY G. BENSON MARKS FOR INCLUSION IN PRINTED RECORD OF SENATE FINANCE COMMITTEE HEARING ON FUNDAMENTAL TAX REFORM (AUGUST 7, 1984)

Critics of the flat-rate tax have claimed that such a system would cause undesirable shifts in the tax burden. They contend that the wealthy would receive a hefty tax reduction while low and middle income earners would have to pick up a heavy tax increase.

However, this supposed shift in the tax burden is not inherent to the flat-rate concept. Rather, it is confined to individual proposals. Properly structured, a flat-rate tax reform could be introduced that would essentially preserve the present allotment of the tax burden.

Such a flat-rate tax could be achieved by following the tax base guidelines proposed by Stanford Professors Robert E. Hall and Alvin Rabushka. Under these guidelines the corporate tax system would be replaced by a comprehensive business tax which would include both incorporated and nonincorporated businesses. Deductions for wages and salaries paid to employees and for purchases of goods and services would be allowed. In addition, the complex accelerated depreciation provisions would be replaced by a one-year write-off for investments in new plant and equipment. This one-year write-off would vastly simplify the investment tax laws, further promote business investment beyond the ability of accelerated depreciation, and inflation-proof the deductible value of investments. These deductions would be taken against a firm's gross revenue from sales. All other existing corporate tax expenditures would be excluded from this reform.

On the individual side of this proposal, the present personal income tax would be discarded in favor of a new personal compensation tax. This tax would be levied on wages, salaries, and paid-out pensions. Other income which has been covered by the personal income tax, such as interest income, dividends, rent income, etc., would not be included in the compensation tax. Instead, this income would be taxed at the source of it's origin under the business tax. Taxing this income again under the compensation tax would be double taxation. Finally, the compensation tax would provide a generous personal allowance.

Unlike the specifics of the Hall and Rabushka tax plan, which would impose a flat-rate of 19 percent on top of the previously described tax base while granting personal exemptions of varying sizes (i.e. $6,200 for married couples, $3,800 for single persons, $5,600 for heads of households, and $750 for dependent children), this tax system would assess a flat-rate of 22 percent on the same business and compensation tax base while providing a flat personal allowance of $6,000 for taxpayers and each dependent.

Based on the present combined tax load of federal indirect corporate taxes and direct personal taxes paid by individuals, this 22%/$6,000 business and compensation flat-rate tax plan would raise the same level of revenue collected through the existing systems while not advancing a shift in the tax burden.

In addition, the 22%/$6,000 flat-rate tax plan would provide a number of improvements over the present structure.

First, the discarding of tax expenditures and multiple tax rate schedules would dramatically simplify the tax laws. As a result, bracket-creep, the marriage penalty, and the problem of disincentives created by marginal tax rates climbing to 50 percent would be eliminated. These improvements would aid in improving voluntary compliance with the tax system, thus increasing tax collections.

Second, the enlargement of the personal allowance from the present $1,000 level to $6,000 would remove the poorest individuals and families from the tax rolls. This would improve the plight of low-income people and decrease the level of federal funds needed to support income-assistance programs.

Third, the 22%/$6,000 flat-rate tax would lower interest rates. Interest income would be placed on an after-tax basis as a result of taxing all non-compensation income at the source under the business tax. This would allow lenders to require lower interest rates without reducing net interest income. Also, the removal of interest expense deductions would induce borrowers to seek lower interest rates. The combination of these two factors in the money markets would promote lower interest rates. Given lower interest rates, the federal government could realize budget savings through reduced debt financing requirements.

Fourth, the shedding of most tax expenditures would release a considerable amount of wealth now sheltered in nonproductive tax avoidance schemes. The lower tax rate would further encourage reinvestment into economically beneficial ventures. The addition to total economic growth that would result from the increased efficiency of existing wealth would increase tax revenues, thereby reducing future budget deficits.

Finally, the melding of these forementioned improvements would assist in alleviating the present budget imbalance without the need for an explicit tax increase.

The implementation of the 22%/$6,000 flat-rate business and compensation tax plan or a close variant would encourage savings and investment and the creation of new job opportunities through a less intrusive tax structure and a more independent and efficient free-market economy.

Thank you.

Respectfully Submitted,

G. Benson Marks

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Tax Reform and Tax Justice

A Statement on the federal income tax
by the Churches' Center for Theology and Public Policy

Prepared by Ronald D. Pasquariello, Senior Fellow

Too many Americans grumble through their tax forms each year, dutifully mail their forms into the IRS, and do nothing about the problems that were the sources of their complaints. We believe that taxes are too important for Americans to repeat that same ritual every year. The system not only impacts our individual lives, but it also shapes the economic and social reality upon which our lives depend. It does this simply by taking money out of our hands and re-allocating it to various government programs.

We believe that the instincts of the American citizens, and many government officials, are right: the system is worth grumbling about. It is in drastic need of reform. And drastic reforms are being proposed for the post-presidential election year.

The Churches' Center for Theology and Public Policy has given some thought to the issue of tax reform and tax justice over the past three years. In this statement we have listed first our concerns about the inequities in the present tax system. The second part of the statement lists some of the more general principles that need to be taken into account by tax policymakers. In the last brief section we address the new proposals: the flat tax, the VAT, and consumption or expenditure taxation.

While the principles enunciated herein have broader application, they are here directed to the present federal income tax system. The need to be brief constrains us from offering an analysis of the whole system, which would include the following: corporation taxes, social security taxes, sales and excise taxes, estate and gift taxes, local and state taxes.

Part One: Inequities in the Current Tax System

1. Any tax deduction benefits those with high incomes more than those with low.

Deductions are used only by those people who itemize their taxes—approximately 30-35% of all taxpayers, who tend to be in the upper income brackets. Furthermore, a dollar of deduction saves the high bracket (50%) taxpayer 50 cents, but saves a low-bracket taxpayer as little as 11 cents.

2. No tax incentive or deduction is free.

They cost the government—and eventually the taxpayer—money, just as any outlay for government programs does. Only the form of the payment differs. Tax deductions, incentives, credits and exemptions now amount to 40% of the federal budget and are climbing.

3. Tax exemptions for some means higher taxes for others.

The government must raise revenue to cover the costs of its operations and programs. If it exempts some from the normal tax structure, then it must raise the rates of everyone else in order to meet its financial obligations. It is estimated that taxes could be lowered by one third just by eliminating all tax expenditures.

4. Anything that sounds like a sales tax is regressive.

Sales taxes are regressive because the poor and low-income persons pay a higher percentage of their incomes in acquiring goods and services so taxed. Sales taxes are also regressive because they tax the basic items which are a larger part of lower-income budgets. Value added taxes and consumption taxes fall into this category and are therefore highly undesireable.

5. Social Security taxes are regressive.

Such taxes are levied only on wage income and not on income from wealth and capital. They are flat taxes on wages and salaries up to a certain maximum. Any raises in Social Security taxes, therefore, are regressive because such taxes take a greater proportion from lower than from higher wage earners, and leave untaxed those whose income is primarily from wealth rather than from wages.

6. Deductions, credits and exemptions add to the complexity of the system.

Each one of these represents one more factor that must be added, subtracted, multiplied or divided in calculating one's yearly taxes. They have increased the complexity of the system enormously and they have given rise to a new cottage industry--tax lawyers who put all of their creative energies into figuring out ways to take advantage of the tax system for their clients instead of how to ameliorate the common good.

7. Tax shelters are paid for by taxpayers who do not invest in them.

A tax shelter is more than a typical deduction. It is an accounting procedure whereby the investor gets a two-to-one or four-to-one return on his/her investment in the form of tax savings rather than of income produced by the investment. The rest of the American taxpayers get no benefit from it, but would have to pay for the claimed deductions through higher taxes.

8. **Flattening tax rates means wringing the progressivity out of the system.**

Despite the advantages accruing from simplicity, the flat rate is not progressive. Simplicity need not be bought at the price of reduced progressivity. Tax expenditures, not the progressive scale, cause most of the present system's problems.

9. **Across-the-board adjustments in rates do little to solve our tax problems.**

Everyone knows now that the 1981 across-the-board cuts in personal taxes benefitted the rich. The main problem with this type of adjustments is that it does nothing to compensate for the injustices in the system. The higher-income taxpayer continues to reap greater advantages than the less affluent.

Part II: Principles for Tax Reform

1. **The income tax system should be used to raise revenue only.**

Originally the income tax system was, with minimimal exceptions, used to raise the monies that the Government needed to meet its financial obligations. This was and is a good purpose. Over recent years an alternate system has been woven into the revenue-raising system. This alternate system consists of the more than one hundred tax exemptions, deductions and incentives that have been added. In 1983, these exemptions totalled $273 billion.

Studies indicate that the case for these exemptions is uneasy. We do not know as a nation whether these exemptions achieve the purposes for which they were created. What is clear however is that they contribute to the complexity of the system.

Our belief is that these purposes can be achieved just as easily and more effectively on the outlay side of the budget. This would greatly simplify the tax system, and put the social and economic policies that we currently try to effect through the tax system in the daylight of the annual debate over budgetary outlays.

2. In taxation, simplicity is a necessary virtue.

The simplicity of a tax is gauged by how well taxpayers understand it and how easily they can comply with its provisions. We believe that in a democracy this kind of simplicity is a moral obligation.

Where the system becomes too complex for taxpayers to understand or comply with, it is unfair because it militates against their participation in shaping the society. The present system makes the benefits of compliance accessible to those who can afford to hire fulltime tax lawyers with fulltime staff to work through the tax maze.

Complexity wastes money. It creates the need to hire tax consultants to determine one's compliance and it requires a large administrative government agency, the Internal Revenue Service, to enforce the tax laws. Complexity also increases the perception of the individual tax payer that the system is unfair.

We believe that a simpler tax system can be devised, one that is within the reach of the average American citizen's ability to comprehend and comply with.

3. Any tax reform should include a comprehensive definition of income.

There are various definitions of income. The present system taxes a reduced mass of income, referred to as taxable income. This is generally defined as gross income minus deductions, credits, exemptions.

For tax purposes, we believe income should include "all additions to a person's wealth over a given period no matter from what source (wages or capital) or how used (consumed or saved)." The present level of taxable income falls about 40% short of this. Exclusions and deductions account for this shortfall.

A system that is not comprehensive, i.e., one that excludes some income--by that very fact favors the possessor of the excluded income. Only very weighty reasons should permit such exclusions.

4. The tax system should not be an intentional instrument of cultural, social or economic policy.

The very fact that we raise revenues, that is, ask Americans to contribute a portion of their income to support our national needs, has unintended cultural, social and economic effects. It takes money, that they might use otherwise, and uses it for purposes determined by our national political processes. That is unavoidable. We believe, however, that such effects should be minimized, and that this is best done by restricting the system to raising revenues only.

Non-revenue-raising policies are best handled through the legislative or budgetary processes. This is in fact the most responsible way to take care of these needs. Tax exemptions, deductions, credits are not subject to close scrutiny or monitoring. The budget process allows us to make independent decsions on which policies we would like to establish as national priorities, and to evaluate these programs carefully.

In addition, the tax system, aside from minimal unintended effects, should not be used to impede savings, investment or productivity. Where these need to be encouraged, that should take place, not through the tax system, but on the outlay side of the federal budget.

5. A progressive tax system is the only fair system.

All Americans make use of the common goods, resources and services of the nation and its government. Some Americans benefit more from these goods and services than others. A moderately progressive tax is fair because it attempts to equitably apportion the accrued costs with the likelihood of increased benefits to those who make greater use of the common goods and services. Progressivity renders fair what would otherwise be a slanting of the economic burden onto those less likely to use the common goods, resources and services of the nation.

6. The tax system should be so arranged that the economically impoverished would not be injured by overwhelming tax burdens.

For various reasons, one of our national goals has been the elimination of poverty. It is generally agreed that the tax system should not increase the burden of poverty on any American. Until recently, federal policy ensured that few people with income below the poverty line were subject to income taxes. Because of inflation, poor people have been pushed into the taxable zone. In the past, adjustments were made in the standard deduction, personal exemption or the earned income tax credit to compensate for the push of inflation. None of this was done in recent law— which is a situation that can be quickly rectified through adjustments in present tax policy.

7. Taxation should not interfere with basic freedoms.

On the one hand, this principle addresses the potential for abuse that resides in the growing power of the IRS. Among possible abuses are: invasion of privacy, circumventing due process, selective special auditing, etc.—all of which abuse the rights guaranteed by the Constitution.

On the other hand, there is the question of those who claim the right of conscientious objection to the payment of that portion of their budget that would go to military outlays. Should citizens have a right to defer from paying taxes where they feel that not to do so would seriously violate their conscience? This form of religious military conscientious objection has been successfully used in the area of military conscription. Some persons have already applied it to the area of taxation. It can be a valid religious protest, in the sense that persons are constrained to follow the dictates of their consciences. The legal and political ramifications need to be worked out.

Part III-New Tax Proposals Evaluated

The Flat Tax

The flat tax fails miserably on fairness. It shifts the tax burden dramatically from high income folks to those in the middle and low income brackets.

In its simplest form, it is an income tax with just one rate and no deductions. The range of taxes that Americans actually pay now varies from 5% to 25% of their incomes. The flat tax rate would probably fall between 15% or 20%. The switch over from our present system, then, would be a tax break for those who now pay above that rate—that is, those Americans who currently earn more than $50,000 per year. It would be a tax raise for those who earn less.

Acknowledging this built-in inequity, flat-taxers have tried to sweeten the pot by allowing some deductions, exemptions or credits. All this does is reduce the degree of unfairness in an inherently unfair system.

The flat tax is a proportional tax, and proportional taxes are never fair. When it comes to purchasing power, it is dollars not proportions that count. Take 20% from an income of $10,000 and from one of $100,000 and the taxpayers are left with, respectively, $8,000 and $80,000. Because a low income family has to pay a greater share of income on basic necessities than a well-to-do family, each dollar taken in tax inflicts more hardship on the low income person.

Emphasizing that the flat tax makes up in simplicity what it lacks in equity is a specious argument. The complexity of the present system comes not from the present progressive scale, which the flat rate would replace, but from the myriad of tax loopholes. Most flat rate systems have already opened the back door for those loopholes. The same amount of simplicity that the flat raters propose can be achieved just by eliminating the loopholes from the present system, while maintaining its progressive rate structure. That would also allow us to maintain some equity in the system.

The Value Added Tax

The VAT is simply a complicated version of the sales tax. The end result is the same. It's just the way it's figured that's different.

A national sales tax would, like state and municipal sales taxes, be a fixed percentage levied on the retail sales of goods. A one-percent national sales tax could yield anywhere from $9-$18 billion, depending on what was taxed.

The strongest argument from the defenders of the VAT is that, since it would be imposed on the current tax structure, it could raise as much as $260 billion annually, which would take care of the deficit with dollars to spare. It, in addition, hits the underground economy, which is inhabited by such denizens as waitresses, plumbers, TV repairmen and the like. Even the electrician who doesn't report his income gets taxed when he buys a new car.

The VAT, they add, is virtually self-enforcing: Buyers get credit when they pay their VAT bills for taxes paid by others along the production chain. It would also give domestic producers a leg-up on foreign competitors: International law allows governments to levy taxes on imports and rebate them on exports.

Given the political will, however, all of these changes could be achieved without switching to another inherently unfair tax system. The VAT is a boiling cauldron of inequity. One way to look at it is that it is a 10% add on tax on wages, because capital investment is exempt.

In addition, sales taxes are the most regressive form of tax: all taxpayers must pay the same rates regardless of income, and, too often sales taxes fall more heavily on low income persons. VAT does nothing to alter the inequities in the present system, and it adds yet another layer of them. Further, it probably would fuel inflation, as it did for the English when Mrs. Thatcher raised Britain's VAT from 8% to 15%.

The Consumption Tax

The consumption or expenditure tax would replace the present income tax. Instead of paying taxes on money earned, it would be paid on money spent.

A dollar saved is a dollar of tax deduction earned in this system. Fundamentally, it replaces all tax deductions and tax shelters by one: savings. One could shelter his income by merely saving it.

It sounds fair, but. . . who is it that has any money to save anyway? That's not difficult to figure out. It is not that half of the American population that earns less than $24,000 a year. The higher one goes in the income ladder, the more disposable income one has. The more disposable income, the greater the freedom of choice to spend it or shelter it in savings.

While the consumption tax is usually presented in its simplest form, there are no end of complexities lurking just below the surface. Even if the tax were made progressive, it would weigh heavily on younger or poorer families that spend heavily on big ticket items like cars, appliances, new homes and the like. It would also hit hard the retired elderly drawing on funds saved for retirement. At the same time it would reward middle-aged and well-heeled taxpayers who can afford to build savings.

It wouldn't change much else. It would not prevent the temptation to under report sales of homes and other assets. It would not reach the underground economy: Illegal funds could be directed into savings accounts, reducing a person's consumption tax liability. High bracket individuals might make loans to low bracket friends, who could then purchase goods on behalf of the lender. Record keeping—of cash balances, bank accounts, other asset holdings, and purchases of durable goods—would not be simplified. And because the new tax base would actually be smaller than the present one, tax rates would probably have to be 5-10% higher than they are now.

Enter the tax expert/lobbyist with an infinite series of adjustments. We'll just allow state and local taxes to be deducted since they do not represent personal consumption, he tells us. And we'll allow the charitable contribution deduction, since that is a transfer not a consumption. And personal health-care costs could be deducted on the ground that they are not voluntary spending. We could spread the purchase price of an auto or major appliance over a number of years. We could also end up back where we started from before we switched to the consumption tax.

Consumption taxation would lead to excessive concentrations of wealth—even its advocates admit that. And that is one of the fundamental problems in a democracy because economic power means political power. A consumption tax gives the most economically successful people in the country a tool with which to legally manipulate their liability, while denying it to others.

The quick brown fox answer of the consumption taxers to this lazy dog concern is simply that we would raise estate and gift taxes to prevent wealth concentration. Well, nowhere in the known world, least of all in the United States, have governments been able to make wealth or estate and gift taxes stick. Besides, many supporters of the consumption tax want to exempt the accumulation of wealth in order to favor investment and economic growth. Now, that's a place that we've been to before. It is precisely this tactic that has caused most of the distortions in the present system

Conclusion

In our view the first necessary step in tax reform is to broaden the tax base of the present system, while retaining the progressive rate structure.The theory of progressivity has been in place for years. It has served us well. It is one of the components of capitalism that has kept the average wage-earning American from being bankrupted, while assuring that those who take more from the socio-economic system pay more for their share. It is one of the structures of American life that makes capitalism morally tolerable. There are political difficulties with engaging that approach to tax reform. However, the missing ingredient in preceding efforts at tax reform has been the American public. The constituency for public interest tax reform is vast but unorganized. We believe that the equitable reform will come once that constituency is organized.

Chamber of Commerce of the United States of America
Washington

STATEMENT
on
MAJOR TAX REFORM OPTIONS
for submission to the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
David E. Franasiak
August 21, 1984

I am David Franasiak, Manager of Tax Policy for the U.S. Chamber of Commerce, and appear today on behalf of our 200,000 business members.

We commend your review of the major tax reform options and are looking forward to working closely with the Committee and staff on this important topic. The Chamber has established a Task Force on Tax Alternatives, comprised of 50 leading tax experts and economists from the private sector, to evaluate the various "flat," "fair," and consumption-based taxes. Our review is underway and should be completed by the end of the year. Therefore, our views at this time are tentative, and will be addressed in greater detail in the near future.

Tax Increases and Tax Reform

The issue of tax reform should be divorced from the question of whether taxes need to be increased. Our position at this time is that not enough has been accomplished on the spending side of the budget. Although it is not widely known, federal spending on social programs in the last 3-1/2 years has increased 28 percent (8 percent after adjusting for inflation). Total federal spending has grown 25 percent (5 percent in inflation-adjusted terms). In other words, notwithstanding the daily rhetoric, federal spending remains out of control.

The deficit should be reduced. The record economic growth we are currently experiencing and federal spending reduction can close the deficit -- if we demonstrate the political will. Merely increasing Americans' tax burden is a short-term, short-sighted "solution" to a critical, seemingly intractable problem. The solution is control of the federal budget.

Tax reform, therefore, can best be accomplished by addressing the issue on a revenue neutral basis. The government should not collect any more nor receive any less revenue. Successful reform will ideally provide a means for collecting a given amount of revenue more efficiently, minimizing the burden that taxes place on the economy.

Principles of Tax Reform

While we are not prepared to comment in detail on the major tax reform proposals, we do subscribe to a set of principles that should be used in evaluating the various tax reform proposals.

o Income tax rates are too high. Although the 1981 tax cuts were a partial step in the right direction, the present tax system, which takes up to one half of a taxpayer's marginal income, continues to inhibit work, savings, investment and economic growth. As the present robust recovery demonstrates, lower tax rates do cause faster economic growth. Furthermore, the government will gain new tax revenue from the increased economic activity.

While we recognize that lowering the tax rates may in the end require base-broadening, we believe there is a great danger that base broadening will become merely another euphemism for tax increase. Clearly, a broader base without a corresponding cut in tax rates would damage the economy and create greater business uncertainty. Congress and the business community may ultimately have to come to grips with the trade off between lower rates and a broader base.

o The tax code should provide a level playing field for all investments. The law should not favor one form of investment over another but should, instead, let the market determine which investments deserve support. Furthermore, any tax reform proposal should eliminate the present system's pervasive bias against savings. The tax code should be neutral between the present and future consumption of income. Present law discourages savings and encourages consumption by taxing both savings and the return on savings.

- The graduation in the income tax rates should be reduced. The present tax system is highly progressive. It should not be used to redistribute wealth from one group of citizens to another, for such an excercise unfairly burdens productivity, work and savings.

- Taxpayers should know how much tax they pay. Some tax reform proposals, like the present tax on corporate income, are structured so that individuals do not know how much tax they are paying each year. Instead the tax is built into the price of every good or service they purchase. A tax system should not misrepresent the facts to the public. The public should be aware of what the government actually costs and those costs should not be hidden. Plainly levied taxes allow the electorate to better judge whether they are getting their money's worth from government.

- No proposed tax system should add significantly to the taxpaying public's already heavy administrative burden. The present tax code is complex. This is largely because of special provisions that treat certain classes of taxpayers more favorably than others. These provision will largely disappear if other principles of tax reform are faithfully followed. Nevertheless, a certain degree of complexity is necessary in any income tax system which fairly taxes a complex, modern economy.

- Taxes should not be raised as a result of inflation. The 1981 tax law introduced indexing into the tax system. For two decades, as inflation pushed taxpayers into higher and higher tax brackets, the government took an increasing proportion of their income. Commencing on January 1, 1985, tax brackets, personal exemptions and zero bracket amounts will increase by the same proportion as income. This will prevent the government from increasing its real (inflation adjusted) tax revenues by debauching the currency. Congress will have to choose, honestly and publicly, to enact a tax increase if it wants to raise taxes.

The Politics of Tax Reform

No one can be opposed to true reform. Reform, however, can mean different things to different taxpayers. Some may believe reform means a net tax reduction while others believe reform will simply ensure that those not paying taxes will begin to pay their fair share. Still others feel the complexity of the tax code and frustration of dealing with the tax system in general are compelling reasons for dramatic change in our present system.

In order to begin to analyze the various tax alternative proposals and assess their impact on our members, we have devised a computer program, the Tax Alternatives Calculator.

By inputting information contained on an individual or corporation's tax return we can quickly determine the taxpayer's liability under various reform proposals, since they all repeal the two earner deduction.

The results are surprising in some cases (see Appendix). Wide swings in liability can occur for ordinary middle income taxpayers. For example, under some reform proposals a retired couple selling their home after their children have grown may pay ten times as much as under present law. Working couples are hurt by most of the proposals, since each repeal the two earner deduction. Some small businesses may find their liability has been doubled by tax "reform."

In conclusion, we urge the Congress to study reform proposals carefully; they are not always as attractive after careful consideration as they appeared on first glance.

Example 1. Husband and wife are both over 65 and retired. He was a salesman for 36 years and receives a pension of $14,000. She was a secretary and receives a pension of $6,000. Now that their family is grown, they are selling their home of 31 years. The original purchase price was only $17,000 but with additions and improvements the basis is $35,000. The home sold for $115,000. The tax liability under various tax reform bills would be:

Present Law	$ 1,787
Bradley-Gephardt	9,832
Kemp-Kasten	2,125
DeConcini	2,527
Quayle	23,040

Quayle repeals the one-time homeowner exclusion for couples over 55; Bradley-Gephardt imposes only the surtax on the couple's capital gain.

Example 2. Working couple with three children and a house. He makes $30,000 working for a contractor. He also receives $3,000 worth of non-taxable fringe benefits. She earns $16,000 as an x-ray technician. They spend $4,800 per year on child care expenses. Mortgage interest expense was $5,000, state and local property taxes were $1,200, state income taxes were $1,500 and other state taxes were $1,200. In addition, they put $2,000 in their IRA.

Present Law	$ 4,390
Bradley-Gephardt	4,802
Kemp-Kasten	3,688
DeConcini	7,005
Quayle	5,220

DeConcini's repeal of the mortgage interest and tax deductions would increase this couple's liability. The others retain most, but not all, of these deductions and the liability is similar but often higher.

Example 3. Small family-owned corporation making furniture. The corporation did not elect under Subchapter S. They invested $30,000 in machinery this year. Sales were $500,000, cost of sales 300,000, salaries, including $50,000 to the owner, were $100,000 and other expenses were $50,000.

Present Law	$4,675
Bradley-Gephardt	12,750
Kemp-Kasten	6,188
DeConcini	3,800
Quayle	5,000

DeConcini is the lowest because capital expenses are expensed and it has the lowest tax rate. Bradley-Gephardt has the least generous depreciation system and repeals the reduced tax rates on small corporations. Kemp by retaining ACRS and lower tax rates on small corporations is lower. Quayle, too, expenses investments.

Example 4. Married couple. He is self-employed earning $70,000 in a consulting business. She is employed as a lawyer for a major corporation and earns $80,000, including $3,000 non-taxable fringe benefits. They also received $30,000 in capital gains from stock holdings. They received $4,000 in dividends and $6,000 in interest. They had $6,000 in mortgage interest expense, $7,000 in real property taxes, $9,000 in state income taxes, and $5,000 in charitable contributions. They have no dependent children.

Present Law	$49,468
Bradley-Gephardt	46,972
Kemp-Kasten	41,625
DeConcini	27,227
Quayle	49,140

DeConcini's low rate and taxation of only wages at the individual level cuts this couple's liability. They generally benefit from the other proposals' lower top rates but loose some deductions and the capital gains exclusion.

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COALITION ON SMOKING OR HEALTH

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THE AMERICAN CANCER SOCIETY

THE AMERICAN HEART ASSOCIATION

THE AMERICAN LUNG ASSOCIATION

SUBMITTED FOR THE RECORD

U.S. SENATE COMMITTEE ON FINANCE

HEARINGS ON MAJOR TAX REFORM PROPOSALS

AUGUST 7 & 9, 1984

"CIGARETTE SMOKING IS THE SINGLE MOST PREVENTABLE CAUSE OF DEATH IN THE UNITED STATES"

Mr. Chairman and members of the Committee, my name is David B. Neumeyer and I am submitting for the record of today's hearing the views of the Coalition on Smoking OR Health and its member organizations, the American Heart Association, the American Lung Association, and the American Cancer Society. The Coalition was founded on March 5, 1982 by the American Cancer Society, the American Heart Association and the American Lung Association to bring smoking prevention and education issues to the attention of legislators and other governmental officials. The Coalition also serves as a public policy project with the National Interagency Council on Smoking and Health, an organization backed by twenty-four public and private health, education and youth leadership organizations.

This year Congress has made a large mistake, one that will affect you, me, and our children for years to come. The nature of the mistake? Congress has decided to allow the excise tax on cigarettes, a product that kills over 340,000 Americans each year and adds $3.8 billion a year in costs to Medicare and Medicaid, to drop to half its current level next year.

Exicse taxes sound dry and uninteresting. They're not. In 1981, when the tax on cigarettes was 8 cents per pack, this single source of revenue provided $2.5 billion for the Treasury. The Tax Equity and Financial Responsibility Aact of 1982 doubled the tax for a three-year period ending October 1, 1985. The Treasury Department has estimated that during fiscal year 1984, cigarette sales will provide $5.1 billion in excise revenues for the federal government. In times when the size of the budget deficit preoccupies the public and Members of Congress, and when the smallest spending cuts and tax increases provoke weeks to bitter argument and negotiation, $5 billion is a very significant sum of money. Yet the House and Senate Conferees on the Deficit Reduction Act of 1984 decided to permit the excise tax to drop next year back to 8 cents a pack, the level which was set in 1951.

Of more concern is the effect of excise taxes on smoking rates: higher taxes mean fewer smokers, particularly fewer teenager smokers. In September, 1983, the Department of Agriculture reported that domestic consumption of cigarettes fell by 4 percent in the first half of 1983. The decrease was attributed in large part to the doubling of the federal excise tax. This decrease represents a 2.3 percent reduction in the number of adult smokers, or one and a quarter million people. Even more significantly, the number of teenage smokers was reduced by 11 percent, or more than half a million. This substantial immediate impact on teenagers could translate into profound changes in the smoking behavior and the long term health of th next generation of Americans. Yet, the conferees chose to allow the tax to drop to half its current level next year.

Congress is going the wrong way with this change. We should be increasing, not decreasing, the excise tax on cigarettes. Cigarette excise taxes are by far the most popular revenue-raising measure available to Congress according to a national poll reported in the February 20, 1984 issue of Time Magazine. The Surgeon General of the United States has declared that cigarette smoking is the single most preventable cause of death and disease in the United States and has cited evidence that unless the smoking habits of Americans change, perhaps 10 percent of all Americans now alive (24 million people) may die prematurely as the result of cigarette smoke. Smoking is, by far, the leading cause of lung cancer, emphysema and chronic bronchitis. It is a major cause of heart disease. Smoking by pregnant women results in an increased risk of stillbirth, miscarriage, premature births and birth weight deficiencies. In economic terms, the yearly cost to our society of cigarette smoke in medical care, Medicare and Medicaid costs, and lost economic productivity approaches $40 billion. Congress should be doing all that it can to increase, not reduce, the cigarette excise tax because increases in the tax saves lives.

Congress' mistake in allowing the Deficit Reduction Act to go to the President without increasing the cigarette excise tax can be rectified next year before the tax drops back down to 8 cents per pack. For the sake of ourselves and our children, we cannot allow the mistake to go uncorrected.

APPENDIX

Press comments on the Treatment of Cigarette Excise Taxes in the Deficit Reduction Act of 1984:

> "The tobacco lobby walked off with the prize for the biggest and most undeserved tax break of the year. With cigarette smoking killing and seriously disabling hundreds of thousands of Americans every year, the conferees voted to cut the federal cigarette tax in half. Here's a decision that will cost the Treasury twice: first in the loss of billions in excise tax revenues; second in added billions in Medicare costs which — the irony is monstrous — other parts of the same bill are trying to restrain."
>
> — Editorial, The Washington Post, June 26, 1984.

> "House and Senate conferees are also working to make it easier to buy cigarettes — easier on the purse, that is. Last week's new tax package let stand a scheduled drop in the cigarette tax from 16 to 8 cents a pack, rejecting even a compromise of 12 cents. By next year, then, Government will let smokers pay appreciably less for a health risk it wants emphasized more."
>
> — Editorial, The New York Times, June 29, 1984.

THE WASHINGTON POST, SATURDAY, JUNE 30, 1984

Ellen Goodman

The Smoking Lamp Is Lit On the Hill

BOSTON—Do you see anything weird in the package Congress has concocted to lower the monster deficit by $50 billion? Anything that seems out of place? Anything that reminds you of the cheerful Sesame Street tune: "One of these things is not like the other/One of these things doesn't belong"?

Way down, deep in the heart of the tax increases, lurks a mysterious stranger: a tax cut. Apparently Congress, even in such perilous budget times as these, felt compelled to support low prices on at least one item vital for the American society. That item is cigarettes.

As of Oct. 1, 1985, if nothing changes, the federal excise tax on a package of cigarettes will be halved from 16 cents to 8 cents. The amount of money raised from cigarettes will also be halved from $4.1 billion to $2.05 billion.

This tax break for smokers did not come about because the cigarette addicts hacked and puffed their way into Congress demanding cheaper smokes. Even smokers seem to believe they should be taxed for their sins. Last winter, in a Yankelovich poll, 77 percent of the public supported increasing cigarette taxes as the single most popular way to raise money for the deficit. Considering that one-third of adults smoke, that's an impressive figure.

It's no surprise that when the cost of cigarettes goes up, their consumption goes down, particularly among the young. According to studies at MIT and the University of Michigan, a 10 percent increase in the cost of cigarettes means a 14 percent drop in sales to teens. The biggest decrease is among teens who decide not to smoke at all.

Presumably most of us would like to see a lower deficit and fewer smokers. So how did this tax cut happen? The short answer is that the 1982 bill which raised the excise tax had a sunset clause in it, promising the tax would return to 8 cents in 1985. The shorter answer is Jesse Helms.

The powerful Republican senator from the tobacco state of North Carolina is in a hard race for reelection. Tobacco states do not look fondly upon cigarette taxes. The House wanted a 12-cent tax on cigarettes, but Senate Republicans went with Helms.

Despite all the politicking, this may be the last time Congress takes a cigarette break. Last week, just as the tax cut was set, a bill was introduced to raise taxes to 32 cents a package and earmark the money for the Medicare trust funds. The appealing concept proposed by Sen. John Heinz (R-Pa.) and supported by the Coalition on Smoking or Health, would make cigarettes help pay for the diseases they cause, especially later in life.

The Wall Street Journal estimates that every $1 spent on cigarettes brings $3 in additional health-care costs. The tax figure—32 cents a pack—has a certain symmetry to it. The 8-cent tax was originally imposed in 1951. If you simply allow for cost-of-living increases, that 8 cents is now 32 cents.

No one knows how high the Medicare deficits are headed, but they are likely to be enormous. The Congressional Budget Office estimates a $97 billion Medicare deficit by 1995. Over a 10-year period, the cigarette tax could contribute about $56 billion.

Some people don't think it's fair to link Medicare and cigarette taxes. After all, smokers may cost us more in terms of health care, but they are also likely to die younger, thereby clearing the Medicare rolls. This is not the sort of argument the Tobacco Institute is likely to use in its famous lobbying.

Lest we get lost in figures, or tempted by greed, the point of the whole plan isn't to raise revenue, it's to discourage smoking. Some of the tax money might well be earmarked—as has been suggested—to help tobacco farmers make a transition to a crop that doesn't kill.

Today, cigarette consumption is finally slumping. I cannot imagine a worse moment for the Congress to encourage sales by cutting costs. A collection of senators has simply put the political health of Jesse Helms above the medical health of millions.

The irony is that this old-time politicking didn't even take place in a smoke-filled room. Few of the senators are foolish enough to still smoke.

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August 3, 1984

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. DeArment:

As you focus on proposals for a flat-rate income tax or for a simplified income tax with few deductions, we strongly urge you to provide for continuance of the charitable gift deduction. Nineteen percent of our operating budget is provided by gifts to annual support and a like amount is provided by endowment earnings. Gifts for endowment and annual support would surely decline in size if the tax incentive were to be removed. Those most affected would be that 25 percent of the student body which is receiving financial aid.

Thank you for your attention.

Yours sincerely,

Robert E. Kaufmann
Headmaster

REK:JAN

EBRI

Summary of Statement of Dallas L. Salisbury
President, Employee Benefit Research Institute

- Employee benefits are a key element of the nation's economic security structure, and have been at the center of tax reform discussions. The Treasury has identified benefits as the means of broadening the tax base.

- Yet, current tax rules meet the Committee criteria of equity, simplicity, balance and economic efficiency. They have broad public support.

- Federal, state, local and private employer-sponsored retirement plans account for 5.3 percent of total compensation. Of all full-time employees in medium and large establishments, 82 percent are covered by a pension plan. Benefit payments exceed $80 billion for a $50 billion tax expenditure, with benefits growing rapidly to complement Social Security.

  Three and one-half percent of total compensation finances employer-sponsored group health insurance. 96 percent of this group of employees are covered by health and by life insurance plans. Benefit payments approach $80 billion for a $17 billion tax expenditure.

- The average taxpayer demanding tax reform does not see employee benefits as a tax abuse. Rather, both employers and employees see these benefits as part of the social contract that defines how, with the assistance of employers, individuals provide for themselves, their families, and their future. This social contract and related tax benefits affect over 150 million Americans. In 1981, employees earning between $15,000 and $50,000 received 71.8 percent of all health-related tax preferences, 64.5 percent of all pension-related tax preferences, and 67.5 percent of all insurance-related preferences.

Any revisions of the tax treatment of employee benefits considered in the context of major tax reform should include several considerations First - distributional impact - the middle-income worker will be the major victim of any such changes. Second - progressivity desired - some treatments would be more regressive than others. In particular, including benefit contributions in the individual's adjusted gross income is the option that would most disrupt the arrangements now used for providing benefits and could also result in the most regressive redistribution of tax liability and benefit coverage. Third - transition - would create significant reductions in public welfare and would exacerbate intergenerational tensions. Fourth - simplification - taxing benefits would actually be more complex than the current system. Finally, the potential revenue gains from taxing benefits should be compared with additional demands that could result on the expenditure side of the budget. Once such a comparison is made, the tax code will be seen as a very efficient means of encouraging employer provision for individual economic security.

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INTRODUCTION

Mr. Chairman, I am pleased to appear before this Committee today to discuss major tax reform options and consequences for employee benefits. Employee benefits are a key element of the nation's economic security structure, and have been at the center of tax reform discussions. In a recent interview on tax reform, John Chapoton, Assistant Secretary of the Treasury for Tax Policy was asked to define broadening the tax base. He responded:

> "A lot of income that taxpayers receive today goes untaxed--employer contributions to pension plans, health insurance, free parking, government payments, those benefits....To produce enough revenue, the flat tax would have to apply lower tax rates to more types of income with fewer deductions."[1]

To aid the Congress in considering tax reform proposals, I would like to provide some background on employee benefits, the tax benefits they receive, and the social benefits they provide (see Appendix I). In my testimony today I will discuss:

- The goals of employee benefits;
- Who receives employee benefits;
- Who receives the tax incentives for these programs; and
- The consequences of alternative major tax reform proposals for employee benefits and, therefore, economic security.

The Employee Benefit Research Institute (EBRI) was formed in 1978 as a non-profit, non-partisan, public policy research organization to conduct research and educational programs. EBRI is committed by charter to the premise that the nation is served positively in both social and economic terms by the existence of employee benefit programs; they can be clearly shown to improve economic security. We are aware, however, that there may be limits to what can and should be provided for both social and economic reasons. EBRI undertakes to provide the studies and the statistics that will allow informed priority decisions to be made based upon assessment of documented costs and benefits.

The press release on this hearing stated:

> "Our interest as a Committee is in building a tax system that will be supported by a broad consensus so that the goals of equity and efficient revenue-raising will not be undermined in the years ahead."

Our research indicates that the present tax treatment of retirement, health, and other risk related benefits meets this criterion. The current tax rules meet the Committee criteria of equity, simplicity, balance and economic efficiency. They have broad public support: Social Securitiy, Medicare, Medicaid, employer pensions, employer health, life and disabilty protection work together to meet a major component of the nation's economic security needs.

These basic benefits are not "tax-ripoffs,", are not viewed by the public as "abusive tax-shelters," and are far too significant to be termed "fringes." Further, consideration of the appropriate tax treatment of these benefits should be clearly separated from debates over "consumption fringes."

THE GOALS OF EMPLOYEE BENEFITS

Employer contributions for all public employer, private employer, and social employee benefits in 1982 constituted 15.8 percent of employee compensation according to Department of Commerce estimates (excludes vacation).[2] These payments constitute most workers' main source of protection against the hazards that may keep them from providing for themselves, their families, and their futures. Together, employer contributions for retirement and health programs, including Social Security and Medicare, account for 85 percent of employer payments for benefits.

Retirement plans. Employer contributions for retirement plans total 9.0 percent of compensation. Federal, state and local and private employer-sponsored retirement plans account for 5.3 percent of total compensation. Contributions for Social Security retirement and disability benefits account for the remaining 3.7 percent.

Health insurance. Employer contributions for health insurance account for 4.4 percent of total compensation. Of this total, 3.5 percent of total compensation finances federal, state, local and private employer-sponsored group health insurance. The remaining 0.9 percent is accounted for by employer contributions for the Medicare component of the Social Security program.

Other risks. Employer contributions also finance unemployment insurance, worker's compensation, and life insurance. These programs protect workers and their dependents against economic uncertainty, and death. Payments for these benefits total 2.4 percent of total compensation.

Fringe benefits. Recent debates over tax legislation have focused on other benefits in addition to the major or traditional categories. The Tax Reform Act of 1984 codified the treatment of benefits like employee discounts and subsidized cafeterias. These benefits are too small as a share of compensation for the Department of Commerce to estimate their value. According to Chamber of Commerce data, these benefits account for 0.6 percent of total compensation.

While traditional benefits make up the largest part of employee benefits, employee benefits have also begun to evolve to meet the needs of the changing work force. Census data show that over the last decade, the proportion of single-adult households with children increased by one-third. Over half of married women are now in the labor force. Single-adult and two-earner households have different benefit needs from those of the traditional single-earner, two-parent family. Many employers now provide child-care benefits, as well as flexible benefit plans that allow single-parent and two-earner families to tailor their benefits packages to meet their specific needs. Cost data on these benefits is not currently available.

WHO RECEIVES EMPLOYER SPONSORED EMPLOYEE BENEFITS?

These benefits are now provided across the income distribution. In medium and large establishments, coverage for major employee benefits is nearly universal. Employee benefits are now a mainstay of the middle-income worker's economic security, building savings as well as providing hazard protection.

Employer Pensions

Of all full-time employees in medium and large establishments, 82 percent are covered by a pension plan (table 1). Small firms, for numerous economic reasons, do not sponsor plans as uniformly. In 1981 the President's Commission on Pension Policy concluded that this could only be changed by mandating plans or by offering tax credits. As firms grow, however, they do add retirement programs. Among employees in all establishments who were covered by pensions in 1983, nearly 28 million (or 59.0 percent) earned less than $20,000 (table 2).

TABLE 1

Percent of Full-Time Employees Participating in Selected Employee Benefit Programs, Medium and Large Establishments, 1983[a]

Employee Benefit Program	Percent of Employees
Private pension plan	82
Health insurance	
employee	96
dependents	93
Life insurance	96
Long-term disability insurance	45
Sickness and accident insurance	49

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics, "Employee Benefits in Medium and Large Firms, 1983," May 1, 1984.

TABLE 2

Distribution of Employees with Pension and Health Coverage by Earnings

Earnings	Employees with Pension Coverage, 1983		Employees with Health Coverage, 1983	
	Total (in millions)	Percent	Total (in millions)	Percent
Less than $20,000	27.9	59.0	83.7	74.3
$20,000 to $49,999	18.1	38.0	26.2	23.2
$50,000 and over	1.4	2.9	2.7	2.4
Total a/	47.4	100.0	112.6	100.0

SOURCE: EBRI tabulations of U.S. Census Bureau *Current Population Survey*, 1983 and EBRI-HHS *Current Population Survey* Pension Supplement.

a/ Detail may not add to totals due to rounding. Totals include only those civilian health and pension plan participants who reported their earnings in the Survey. When those not reporting their earnings are added, coverage totals are higher.

Pensions redistribute wealth to favor those at the lower end of the income scale who do not tend to save much out of current income. According to the EBRI/U.S. Department of Health and Human Services (HHS) May 1983 Current Population Survey (CPS) Pension Supplement, accumulated pension benefits constitute the major form of savings for more than half of all persons with pension coverage. More than 40 percent of the labor force reported no savings income in 1983 (table 3). This group's average income was $9,651, just under half the average income of those reporting some asset income. Almost half of the group reporting little or no savings income were covered by employer pensions, however. Pensions thus constituted a net increase in savings for these workers. As the Committee press release noted, assessments of pension-related tax policies should consider the net increase and redistribution of wealth that results from expanded pension coverage.

Not all retirement benefits exhibit the same income distribution patterns, however. In particular, statutory provisions aimed at encouraging individual provision for retirement differ considerably. While 59 percent of pension participants earn less than $20,000, 46.5 percent of individual retirement account (IRA) holders and 34.8 percent of those participating in Section 401(k) plans fell into this income group (table 4). Section 401(k) plans in particular follow a different income distribution from both IRAs and employer-sponsored plans. More than half of Section 401(k) plan participants earn between $20,000 and $50,000, compared with under 50 percent for both IRAs and employer-sponsored plans.

Health insurance

Of all full-time employees in medium and large establishments, 96 percent are covered by health and by life insurance plans (table 1). Among

TABLE 3

Savings, Pension Coverage, and Income, 1983

Savings Status[a]	Employees Covered[b] (Millions)	(Percent)	Employees Not Covered (Millions)	(Percent)	Average Annual Income (Dollars)	(Percent)
No savings	18.2	19.0	20.6	21.5	$ 9,661	40.5
Some savings[c]	36.9	38.4	20.3	21.1	19,209	59.5
Total	55.1	57.4	40.9	42.6	15,338	100.0

Source: Sophie M. Korczyk, Retirement Security and Tax Policy (Washington, D.C.: Employee Benefit Research Institute, forthcoming.

[a] Individuals are classified as having some savings or no savings based on whether or not they reported any asset income in response to the survey questions. Asset income includes interest, dividends, rents, and royalties.
[b] Coverage refers to public- and private-sector pension plans and includes holders of IRA or Keogh accounts.
[c] Includes individuals reporting negative asset income (i.e., decreases in asset values).

Table 4

Percent Distribution of Participation in Retirement Programs, by Earnings, 1983

Earnings	Pension Plan	401(k)	IRA
$ 1 to $19,999	59.0	34.8	46.5
$20,000 to $49,999	38.0	55.7	45.4
$50,000 and over	2.9	9.5	8.0
Number of workers (in millions)	47.4	1.9	16.7

SPURCE: EBRI tabulations of U.S. Census Bureau Current Population Survey, 1983 and EBRI-HHS Current Ppopulation Survey Pension Supplement.

all employees with employer-provided health coverage, 83.7 million (or 74.3 percent) earned less than $20,000, and 23.2 percent earned between $20,000 and $50,000. About 35 percent of all spending on health care that does not pass through government programs is now made through employer-sponsored plans.[3] Fewer than 3 percent of pension and health insurance participants earn more than $50,000.

EMPLOYEE BENEFITS AND THE TAX CODE

The tax code is a major influence in the growth of employee benefits. One effect results from provisions that allow some employer contributions and some employee contributions to finance benefits on a tax-preferred basis. Another major impact stems from the inflation-driven increases in real tax rates of the last 20 years. While statutory tax rates have been falling at most income levels, real tax rates have risen. Inflation has overwhelmed the tax rate cuts enacted over this period. To stem the erosion of real income brought about by this "bracket creep," employees have negotiated compensation packages in which benefits have played an increasingly important role. It is interesting to note, however, that this trend has abated with increasing emphasis on 401(K) salary reduction programs that are subject to FICA tax and employer attention to health care cost-containment.

Employee benefits are also now playing a major role in tax policy. As directed in the Congressional Budget Act of 1974, the President's annual budget submission to Congress lists each year's tax expenditures. These are benefits perceived to flow to certain taxpayers as a result of the statutory treatment of certain sources or uses of income.

Of the 51 tax expenditure provisions that benefit individuals, 20, or nearly 40 percent, affect the tax treatment of privately- and publicly-provided employee benefits. This seems consistent with the nation's commitment to economic security. Two provisions--those governing the tax treatment of employer-sponsored retirement plans and health insurance plans--account for nearly two-thirds of total benefit-related tax expenditures projected in the President's 1985 budget.

Employer pensions account for nearly 50 percent of benefit-related tax expenditures. There is wide disagreement, however, about the proper way to measure these costs. Tax-expenditure measures used in the federal budget process are calculated on a cash-flow or cross-sectional basis, with the taxes deferred by current pension plan participants offset against the taxes paid by current beneficiaries. Measured this way, about $0.83 out of every tax-deferred dollar appears to be lost to the Treasury.

Recent EBRI research, however, suggests that such estimates overstate the amount of revenue lost due to these provisions. Because today's pension-plan participants will have higher retirement incomes than today's retirees, they will pay more taxes in retirement. Over their lifetimes, employees now at the beginning of their pension careers will repay all but $0.25 to $0.40 of every tax-deferred dollar. As the pension system matures, the numbers and income levels of pension-plan participants and retirees will differ less than they do today. As a result, in the future, pension-related tax expenditures measured using the Treasury's approach will be much closer to lifetime estimates.[4]

From the standpoint of long term social and economic policy, however, the difference between tax exemption and tax deferral must always be noted: these programs both reduce demands on Social Security and contribute to the public consensus for Social Security (table 5).

TABLE 5

How Much of Pension-Related Tax Deferrals is Lost to the Treasury?

Method Used	Taxes Lost	Taxes Deferred
Treasury Method	83%	0%
Lifetime Method:		
Nominal dollars[a]	14	86
Real dollars[b]	28	72
Discounted for interest:[c]		
at pension rate	40	60
at federal rate	36	64

SOURCE: Sophie M. Korczyk, Retirement Security and Tax Policy (Washington, D.C.: EBRI, forthcoming).

[a] Before adjusting for inflation.
[b] After adjusting for inflation.
[c] Interest rate used to discount taxes paid in retirement to the year of retirement.

WHO BENEFITS FROM TAX INCENTIVES?

The average taxpayer demanding tax reform does not see employee benefits as a tax abuse. Rather, both employers and employees see these benefits as part of the social contract that defines how individuals provide for themselves, their families, and their future. This social contract and related tax benefits includes the majority of the U.S. labor force.

The distribution of benefit-related tax benefits among income groups reflects the distribution of coverage and participation. In 1981, employees earning between $15,000 and $50,000 received 71.8 percent of all health-related tax preferences, 64.5 percent of all pension-related tax preferences, and 67.5 percent of all insurance-related preferences (calculations based on table 6). This group pays 51 percent of total federal taxes.[5] By comparison, this income group received 64.2 percent of tax benefits related to homeownership. It would seem that employee benefits are less of a luxury than owning your own home.

THE TAX REFORM MOVEMENT

Tax reform is a perennial topic of discussion. At least a dozen major tax reform proposals were introduced in the 97th Congress. More tax reform proposals were introduced in the 98th Congress. Some legislative proposals call on the Treasury to study major tax reform, while others contain detailed amendments of the Internal Revenue Code. President Reagan has also asked that the Treasury department analyze basic tax reform options and prepare a report by December 1984.

At the heart of the major tax reform movement is the widespread belief that the tax system is unfair and inefficient. The middle-income taxpayer feels that he or she is paying the bill for the loopholes of the wealthy.

The tax system is considered by some to be inefficient because investment and other economic decisions are often driven as much or more by tax needs as by economic returns and productivity considerations. High marginal tax rates encourage taxpayers to seek out tax-favored sources of income--capital gains, for example--and tax-favored uses of income, such as housing.

Major tax reform proposals offer ways to restructure--not lower--the nation's tax bill. Major tax reform proposals such as the flat tax, the "fast" tax, the consumption tax, and the gross income tax, would lower marginal tax rates and expand the income tax base. These proposals would

TABLE 6

Revenue Loss for Major Benefits and Taxes Paid by Income Class as Percent of Total Adjusted Gross Income Class, 1981[a]

Adjusted Gross Income Class	Exclusion of Employer Contributions for Medical Insurance & Medical Care	Exclusion of Worker's Compensation Benefits	Exclusion of Untaxed Unemployment Insurance Benefits	Exclusion of Disability Pay	Net Exclusion of Pension Contributions & Earnings[b]	Exclusion of Insurance Premiums[c]	Percent of Total Taxes Paid
Less than $10,000	6.5%	29.4%	50.6%	83.0%	4.0%	4.5%	2.6%
$ 10,000 to $ 15,000	8.7	16.6	26.4	14.4	5.6	6.1	5.7
$ 15,000 to $ 20,000	10.7	11.7	9.7	6.7	7.8	8.8	8.0
$ 20,000 to $ 30,000	28.3	24.8	12.8	2.0	22.6	24.0	20.6
$ 30,000 to $ 50,000	32.8	12.9	0.4	-	34.1	34.7	30.4
$ 50,000 to $100,000	10.6	3.5	-	-	17.8	15.2	18.1
$100,000 to $200,000	1.9	0.7	-	-	6.0	4.8	8.3
$200,000 and over	0.4	0.3	-	-	2.1	1.9	6.3

SOURCE: EBRI calculations based on U.S. Congress, Congressional Budget Office, Revising the Individual Income Tax, July 1983 (Washington, D.C.: U.S. Government Printing Office, 1983), Table 9, pp. 62 and 63.

NOTE: Percents may not add to 100.0 percent due to rounding.

[a] 1981 income levels and 1982 law.

[b] Includes the exclusion of contributions and earnings for employer plans and plans for the self employed and others.

[c] Includes premiums for group-term life insurance and accident and disability insurance.

change the distribution of tax liability among individuals by eliminating many tax preferences in current law. Another set of proposals would raise additional revenue through a broad based value added or sales tax.

The arguments for broadening the tax base have attracted a wide range of political support. Conservatives support broadening the tax base as a way of eliminating the income-earning disincentives and market interference of high marginal tax rates. They also prefer individual decision-making to employer or government decisions made on the worker's behalf. In this view, Individual Retirement Accounts (IRAs) are preferable to either Social Security or employer pensions as a means of providing for retirement.

Liberals support broadening the tax base as a way of eliminating tax-code provisions perceived to benefit primarily the rich. They also prefer direct government expenditures over the tax subsidies that might arise from tax incentives.

EMPLOYEE BENEFITS IN MAJOR TAX REFORM PROPOSALS

While tax reform has broad support, it would also have widespread costs. One of the most important consequences of tax reform proposals that seek to restructure the tax system for the average taxpayer would be to change the tax treatment of employer contributions for employee benefits.[6]

Comprehensive Income Tax

A comprehensive tax attempts to tax both actual and imputed income. Many comprehensive income tax proposals include in taxable income not only cash wages but also all or most employer contributions for employee benefits on a current basis.

Consumption Tax

The consumption tax would tax all income that is spent, excluding saving from taxable income until the funds were used for consumption. The consumption tax would therefore tax all employer contributions for benefits that do not result in saving. This includes the various employee benefits that provide insurance protection, like health insurance plans, life insurance, and disability insurance. Since cash compensation would continue to be a tax-deductible cost of doing business to the employer, the employer would presumably have an incentive to offer more compensation in cash than in benefit contributions.[7]

Value-Added Tax

For any one employer, value added is the difference between receipts from sales and amounts paid for materials, supplies, and services purchased from other firms. Total value added for the entire economy is equal to total wages, salaries, interest, rents, and profits. Like the current income tax, the value-added tax could include or exclude employee benefits in the tax base.

Federal Sales Tax

A federal sales tax would have the same effect as some forms of the value-added tax. The difference is that a federal sales tax would be levied at the point of sale, while a value-added tax is imposed at each stage of production. Since a sales tax imposes tax liability on the total value of the product, it would implicitly tax employer outlays for employee benefits since these outlays are a cost of production. It would likely have little effect, however, on either employer or individual behavior regarding the provision of employee benefits.

ISSUES IN IMPLEMENTATION AND TRANSITION

This committee expressed an interest in implementation and transition issues in basic tax reform. These problems could be formidable, and even predicting them involves some uncertainty about the reactions of employers, employees, and insurers and other providers of benefits. This uncertainty arises from the fact that the availability of tax incentives for employee benefits has influenced how plans are provided and designed. For example, because employee benefits are purchased on a group basis, employers and employees can benefit from economies of scale. Therefore, a dollar spent on employee benefits by an employer buys more than would the same dollar spent by an individual. In the absence of tax incentives encouraging employer provision, the administrative structures that make group purchases cost-effective may never have been developed.

Alternative treatments for employee benefits that have been proposed include:

- Including benefit contributions in the employee's adjusted gross income;
- Eliminating employer deductions for benefit contributions;
- Capping the share of total compensation that can be provided in the form of tax-favored employee benefits;
- Imposing an excise tax on the employer's benefit contributions; and
- Imposing a value-added or national sales tax.

The issues and economic effects that arise under each approach differ considerably.

Including Benefit Contributions in Adjusted Gross Income

Most plans do not determine the costs of employee benefits on the basis of the characteristics of the individual for whom protection is being provided. These pricing structures are reasonable from employer's viewpoint given current tax treatment, since the total cost of insuring the employer's work force is not affected by the allocation of these costs among the members of the covered population. They are irrelevant to the employee who cares only about the total amount of insurance provided, and not about how the cost of this insurance is billed to the employer.

If employer contributions for benefits were taxed to the employee, the entire pricing and cost allocation structure of benefit plans could have to be revised to allocate contributions appropriately among individuals. While the average price of providing employee benefits to various employees may be uniform, the underlying cost of benefits differs widely according to the employee's age under all major benefits. Benefits for younger employees are less costly because these employees generally have lower health insurance claims, disability rates, and mortality rates. The adjustments that would be required would vary across benefits.

Pensions Actuarial methods used in defined-benefit pension plans do not generally allocate contributions or projected benefits to individuals, determining them instead for an employee cohort based on aggregate forecasts of that cohort's future demographic and economic experience. If defined-benefit pension costs were allocated among individuals, it would become clear that financing a given retirement benefit requires a lower contribution for a younger employee than for one closer to retirement age. The contribution for the younger employee can accrue interest over a longer period of time, while the same benefit increment for an older employee has to be financed primarily out of employer contributions.

Pension costs in a defined-benefit plan may therefore be 14 times as high for an employee at age 60 as at age 30 (calculations based on table 7). Attributing an average pension contribution to each employee would create serious inequities. Older employees would be undercredited, while younger employees would be overcredited. To the extent that older employees earn more and are taxed at a higher rate than younger employees, this inequity would be compounded.

Health Insurance Employer contributions to finance health insurance are similarly based on the total cost of insuring a particular employee group.[8] Underlying costs for health insurance can be twice as high at age 60 as they are at age 30 (calculations based on table 9). Similarly, the underlying cost of providing health insurance for women of child-bearing age is higher than the cost of insuring young, single men. In short, the average price of most employee benefits is much higher than the cost of providing benefits to some individuals and much lower for others.

Options for Alternative Tax Treatment

If employer contributions for benefits were included in the tax base, they might be treated in the same way that the Internal Revenue Code now treats employer-paid life insurance premiums for coverage in excess of $50,000. These premiums are currently included in the tax base. The cost of life insurance varies according to the individual's age. For example, at age 30, the cost of providing life insurance worth an individual's annual salary is 17 percent as large as it is at age 45, while at age 60 this cost is nearly 4 times as large (calculations based on table 7).

To avoid the inequities that would arise if all individuals were taxed on an average cost of insurance, Treasury regulations prescribe the amount of

TABLE 7

BENEFIT COST FACTORS FOR EMPLOYEES AT VARIOUS AGES

Age Group	Medical Cost Factor as % of Cost at Age 45-49	Defined-Benefit Cost Factor as % of Cost at Age 45-49[a]	Life Insurance Cost Factor as % of Cost at Age 45-49[b]
Under 30	80.0	23.0	17.0
30-34	80.0	33.0	17.0
35-39	80.0	48.0	33.0
40-44	80.0	69.0	50.0
45-49	100.0	100.0	100.0
50-54	112.5	146.0	170.0
55-59	125.0	216.0	250.0
60-64	160.0	323.0	383.0
65-69	225.0	c	383.0

SOURCE: Anna M. Rappaport, F.S.A. and Malcolm H. Morrison, Ph.D., The Costs of Employing Older Workers (Washington, D.C.: U.S. Senate Special Committee on Aging and the Employee Benefit Research Institute, forthcoming).

[a] Defined contribution plan costs do not vary by age.

[b] Same life insurance cost is assumed for 65 to 69 as for 60 to 64 because it is assumed that the benefits will be reduced to equal cost; regulations allow a 30 percent reduction. If benefits are not reduced, assume costs at 65-69 are about 30 percent higher. Figures assume life insurance provided is worth one times pay.

[c] Pension costs for these employees depend on the plans's design.

premiums to be recognized as income for individuals on the basis of age (in five-year brackets) and coverage levels. The Treasury tables use blended actuarial assumptions for men and women based on the proportions of men and women in the group of employees with coverage over $50,000 in value.

To achieve an equitable distribution of tax liability, a schedule like that governing the tax treatment of life insurance would probably have to be developed for all employee benefits. Given the Supreme Court's decision in the Arizona v. Norris case, such tables would probably not be differentiated by sex. Such tables could, however, be differentiated by age, family status, or both. Family status could be used to predict health insurance claims under plans that offer maternity or dependents' benefits.

Effects of Taxing Benefits

The effects of taxing benefits would vary among benefits and would depend on whether or not individuals chose to continue their coverage. If pension accruals were taxed on a current basis, saving would almost certainly decline, and would decline disproportionately among those at lower income levels who do not tend to save out of current income.

To avoid the added tax liability, many low- and moderate-income individuals would choose to do without health and other types of insurance. Research conducted by the Employee Benefit Research Institute (EBRI) and others indicates that income determines whether or not people without employer-provided health coverage purchase such coverage themselves. If employers did not provide health coverage, most low-income workers would not purchase private health insurance.[9] Since most people covered by an employer health plan are members of low- and middle-income families, employer-provided health benefits probably substantially raise rates of private health insurance coverage throughout the nonelderly population.

For those who chose to continue their insurance coverage, the impact of a tax on health insurance premiums would be regressive. While employer contributions for life and disability insurance are based on the employee's earnings, contributions for health insurance are not. As a result, the value of employer-provided coverage is a larger share of total compensation at lower income levels and the added tax payment of low-income workers would be a larger share of their income than at higher income levels. EBRI tabulations of data produced by the Congressional Budget Office (CBO) indicate that under the Administration's proposal to cap the amount of health insurance premiums that an employee can receive tax-free, those with the lowest incomes would pay more than six times as much tax as a percent of income as those with incomes above $50,000.[10]

The flatter rate structure of some major tax reform proposals would exacerbate this regressivity. Under current-law rates, the progressivity of the tax schedule offsets the effect on tax liability of the declining share of health insurance in compensation at higher income levels.

In short, whatever the criterion used for determining the cost of each employee's cost of benefits, if it targeted those individuals likely to have the highest incidence of claims, it would also target those most likely to need insurance. Since those most likely to become sick, disabled, or die would face the highest tax liability, taxing employer contributions for benefits would impose tax liability in inverse proportion to ability to pay.

Another potential effect of taxing employee benefits to the individual could be to increase the attractiveness of flexible compensation or cafeteria plans. Under flexible compensation plans, employees can elect various levels of coverage under the major types of employee benefit plans. An employee choosing a less-generous health insurance plan, for example, can "spend" the employer's cost savings on added life insurance, vacation days, or other benefits. All employees--except for those who chronically guessed wrong about their need for health insurance or other benefits--would segregate themselves into plans according to the expected value of their claims. While this is the fundamental principle behind flexible compensation plans, many employers sponsoring these plans now price the high-cost insurance options at less than the value of the claims expected under them to maintain a reasonable risk pool of participants under each option. If employees were being taxed on the value of employer contributions, however, such subsidies would probably have to stop, since they would mean that low-risk employees would be paying the tax bill for higher-risk persons. If all persons chose plans priced at the expected value of their claims, the risk-sharing inherent in group insurance plans would be eliminated.

Eliminating Employer Deductions for Employee Benefits

Some of these distributional problems could be avoided in major tax reform proposals that would include nonpension employee benefits in the tax base by eliminating employer tax deductions for them. The value-added tax could have this effect, depending on how it was designed, and some versions of the consumption tax would provide for this.

Faced with such a provision, employers who now offer benefits would probably cut them back and those who do not would probably not institute them. Some employers who offer benefits might eliminate them or continue to offer them with full employee payment. Others might forego improving their benefit packages, while still others might institute or increase employee contributions, deductibles, or copayments where appropriate. Employers are already working to reduce their benefit costs; including benefits in the tax base would clearly accelerate this process but at a social cost.[11]

The greatest impact of proposals to eliminate employer deductions for benefits would probably be on those employees who are not now covered. Most employees without benefit coverage tend to be in smaller firms and at lower income levels. As small and new firms grow and become profitable, they are more likely to incur the financial commitment involved in establishing employee benefit plans. Removing the tax deductions for employee benefits would probably make this commitment uneconomical.

Capping Employee Benefits as a Share of Total Compensation.

Another alternative that has received some attention in tax policy debates--though not necessarily in the context of major tax reform--is establishing a limit on the share of total compensation that can be provided in the form of tax-favored employee benefits. Benefits provided in excess of this amount would be subject to payroll tax, income tax, or both. Under alternative proposals, the cap could cover contributions for all benefits, or pensions, welfare benefits, and so-called "fringe" benefits could all be capped separately.

Such an approach could raise its own set of problems. For example, an employer with a mature, long-tenure work force could be put at a competitive disadvantage compared with an employer with a younger work force, even if the benefits in the two firms were identical. Furthermore, a cap could act as a target that firms with less-generous benefit plans would feel compelled to meet to maintain their competitive positions. The efforts of such employers to catch up could offset the effects on employers whose benefits exceeded the cap. Such a system could also be difficult to implement for non-profit or public-sector employers, neither of which pay business profit taxes.

Of the four alternatives that tax reformers have proposed, however, only the national sales tax would offer employers and employees more flexibility than the tax cap to choose among benefits and to choose the level of coverage to be provided under major benefits. Establishing a tax cap, however, would point up the difference in the tax treatment of insurance provided under the employer's auspices compared with the treatment of insurance purchased by the individual directly. While persons without pension coverage can establish IRAs on a tax-preferred basis, those without health or other insurance pay for such protection with after-tax dollars. A tax cap combined with provisions allowing individual purchases of insurance with before-tax dollars could mitigate the detrimental effects on expansion of coverage that could result from taxing employer contributions for benefits.

An Excise Tax on Benefits

Rather than capping benefits as a share of compensation, it would be possible to impose an excise tax on all tax-favored benefits, whatever their level. This was proposed by the Treasury to this Committee in Testimony of June 1983. This would avoid creating a target benefit level for employers to reach. An excise tax, however, would have the same effect on benefits as eliminating employer deductions for benefit contributions. Employers now offering benefits would cut them back, while those without benefits would probably not institute them. The only difference between the two options would be in the tax rates they would impose. If an excise tax carried lower rates than the corporate or business taxes the firm might be paying, then the incentives to eliminate benefits would not be as strong.

A Value-Added or National Sales Tax

Instituting a national sales tax or a value-added tax would not have the same effect as a tax levied specifically on benefits. Any tax levied at the point of sale or at different stages of production would be neutral between wages and benefits as a form of compensation and thus would not change employer and employee preferences.

CONCLUSIONS AND POLICY IMPLICATIONS

Basic tax reform appeals to a broad constituency. Current and projected deficit levels pose a threat to the economy; it may be that only sweeping changes in the tax structure will allow the federal government to raise adequate revenues to eliminate this threat.

The basic tax reform movement is motivated in part by the erosion of the income tax base due to the proliferation of both business and individual tax preferences. As the Congress proceeds with these discussions, it will be confronted with representatives of almost every special interest that benefits from the 106 provisions in the code that lead to tax expenditures, and whose elimination could hurt the pocketbooks of these interest groups. One group will probably not be represented in these discussions, however. The average working person, who takes for granted the health, pension, and insurance benefits provided in his or her compensation package, almost surely does not think of employee benefits as a tax loophole.

The Congress, however, is charged with taking a perspective on these issues that transcends the concerns of special interest groups. In particular, it is essential that major tax reform debates look beyond revenue-raising considerations alone and examine the broader economic implications of eliminating incentives now built into the tax code.

Many of these incentives were designed to further social and economic goals that could not be efficiently pursued through the expenditure side of the budget. The elimination of these incentives in the name of short-term budget goals could lead to much higher costs for the federal government in the future. When compared with the costs of assuring economic security through direct federal spending, tax incentives for employee benefits may turn out to be a bargain. For example, according to Department of Commerce data, employer-based pensions now provide over half as much retirement income as the Social Security program.[12] If employer pensions were eliminated and Social Security benefits were to be increased by 50 percent, the deficit projected in the President's budget proposal would have been almost 60 percent higher. Could the economy sustain such an increase?

Tax incentives for health insurance raise similar issues. Tax expenditures attributed to the tax exemption of employer contributions to health insurance were estimated at $17.6 billion in 1984.[13] This may be a relatively low price for society to pay for a system of health insurance that may pay as much as $90 billion in benefits in 1984 and serves more than 60 percent of the population. In 1984, by comparison, federal spending for Medicare is expected to total $62.2 billion dollars; federal-state spending for Medicaid is estimated at $37.8 billion.[14] Together, these public programs finance health care services for only about 18 percent of the population.

In any revisions of the tax treatment of employee benefits, several considerations should be prominent. First - distributional impact - the middle-income worker will be the major victim of any such changes. Second - progressivity desired - some treatments would be more regressive than others. In particular, including benefit contributions in the individual's adjusted gross income is the option that would most disrupt the arrangements now used for providing benefits and could also result in the most regressive redistribution of tax liability and benefit coverage. Third - transition - would create significant reductions in public welfare and would exacerbate intergenerational tensions. Fourth - simplification - taxing benefits would actually be more complex than the current system. Finally, the potential revenue gains from taxing benefits should be compared with additional demands that could result on the expenditure side of the budget. Once such a comparison is made, the tax code could prove to be a very efficient means of encouraging private provision for individual economic security.

NOTES

[1] "Our Complex Tax Laws: Can They Be Reformed?" *U.S. News and World Report*, July 30, 1984.

[2] This total includes Social Security contributions; unemployment insurance; workmen's compensation; private pensions and profit-sharing plans; federal, state and local government employee retirement plans; group health insurance, group life insurance; and supplemental unemployment benefits.

[3] Unpublished EBRI estimate.

[4] For further detail on these estimates, see Sophie M. Korczyk, *Retirement Security and Tax Policy* (Washington, D.C.: EBRI, forthcoming), Chapter IV.

[5] EBRI calculations based on U.S Congress, Congressional Budget Office, *Revising the Individual Income Tax* (Washington, D.C.: U.S.Government Printing Office, 1983), Table 9.

[6] Alternative tax systems would require detailed judgments about the treatment of various sources and uses of income. Both would also create some formidable implementation and transition problems. These problems and issues are treated in detail elsewhere. For a discussion of employer pensions in basic tax reform, see Sophie Korczyk, *Retirement Security and Tax Policy* (Washington, D.C.: EBRI, forthcoming) and "Basic Tax Reform: Implications for Employee Benefits," EBRI *Issue Brief* no. 28, March, 1984. For a wide-ranging discussion of theoretical and practical issues in basic tax reform, see Dallas L. Salisbury, ed., *Why Tax Employee Benefits?* (Washington, D.C.: EBRI, 1984).

[7] This argument is advanced in Robert E. Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax* (New York: McGraw-Hill Company, 1983), p. 90.

[8] In smaller plans, the cost of providing health insurance for the marginal employee is based on the average costs of insuring the insured population of that community. In larger plans, the cost of insuring the marginal employee is based on the average cost of insuring the population represented by that employer's work force. While these two methods would be likely to yield different insurance costs for any given employee, under either method the cost of insuring that employee does not represent the cost of that employee's expected claims.

[9] Deborah J. Chollet, *Employer-Provided Health Benefits: Coverage, Provisions, and Policy Issues* (Washington, D.C.: Employee Benefit Research Instititute, 1984), p. 94. An EBRI simulation of private health insurance suggests that 56 to 87 percent of all covered workers with 1979 family income less than $15,000 would not have purchased private health insurance, if an employer had not offered and contributed to their health insurance plan.

[10] Deborah J. Chollet, Employer-Provided Health Benefits: Coverage, Provisions and Policy Issues, p. 100. For a discussion of taxing employer contributions to health insurance, see also "Revising the Federal Tax Treatment of Employer Contributions to Health Insurance: A Continuing Debate," EBRI Issue Brief no. 21, August, 1983.

[11] For a discussion of employer efforts to reduce health care costs, see "Controlling the Cost of Health Care: Recent Trends in Employee Health Plan Design," EBRI Issue Brief No. 23, October, 1983.

[12] In 1981, the latest year for which complete data are available, Social Security Old Age, Survivors', and Disability benefits were $138.6 billion,, while private-sector and federal, state, and local government retirement plan benefits were $73.2 billion.

[13] Budget of the U.S. Government, Fiscal Year 1985, Special Analysis G.

[14] Deborah J. Chollet, "Assuring Economic Security for Workers: Health, Disability, and Life Insurance Benefits," Statement before the United States Senate Finance Committee, Subcommittee on Taxation and Debt Management, Hearing on Fringe Benefits, July 26, 27, and 30, 1984.

EBRI Research Related to Major Tax Reform

Books

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Appendix I

For legislative policy assessment purposes benefits can be classified into at least nine categories:

1. legally required benefits (including employer contributions to Social Security, Medicare, unemployment insurance and workers' compensation insurance);

2. discretionary benefits that are fully taxable (primarily, payment for time not worked);

3. discretionary benefits that insure the employee against financial risks and are tax exempt (including employer contributions to health, life, and disability insurance plans);

4. discretionary benefits that help the employee meet special needs and are tax exempt (including employer contributions to child care and legal plans);

5. discretionary benefits that have traditionally been called fringes and are intended to meet employer needs and are tax exempt (including employer provision of purchase discounts, job site cafeterias, special bonuses and awards, van pools, clubs, and parking);

6. discretionary "reimbursement account" benefit programs that have been legally allowed since 1978 which allow employees to have reimbursement accounts--funded by the employer or through salary reduction--to pay expenses that fall into "statutory benefit" areas and are tax exempt (including health care reimbursement, child care reimbursement, etc.);

7. discretionary benefits that provide retirement income as a stream of payments and for which taxes are deferred until benefits are received (including employer contributions to defined benefit pension plans and to defined contribution plans which require payment in the form of an annuity);

8. discretionary benefits that provide for the deferral of salary until termination of employment, generally pay benefits as a lump sum, and for which taxes are deferred until benefits are received (including contributions to some profit sharing plans, to money purchase plans and ESOPs); and

9. discretionary benefits that provide for the deferral of salary until special needs arise (loans and hardship), or until termination of employment, generally pay benefits as a lump sum, and for which taxes are deferred until benefits are received (including contributions to some profit sharing plans, thrift-savings plans, and salary reduction plans).

During a time when there are no apparent limits on direct federal expenditures, or on "tax incentives," analysis may not need to focus on the diversity of employee benefits. During a time of apparent limitations, however, when priorities must be decided upon, careful analysis is required of eacn employee benefit: why each employee benefit exists.

* Taken from a statement on EMPLOYEE BENEFITS AND ECONOMIC SECURITY by Dallas L. Salisbury before the United States Senate Finance Committee Subcommittee on Taxation and Debt Management hearing on Employee Fringe Benefits, July 26, 27, and 30, 1984.

UNITED STATES SENATE

COMMITTEE ON FINANCE

Hearings on Options for A Major Revision of the Tax System

August 7th and 9th, 1984

Statement of Grant Sykes
On Behalf of The Institute for
the Study and Encouragement of
Common Sense Economics

Gentlemen, I am pleased to present the views of The Institute on the subject of A Major Revision of the Tax System.

When examining the present tax system it becomes clear where things went wrong. We have failed to understand the economics of taxation and the doleful nature of the incidence of various taxes upon the national economy. Our grievous tax system led to mistakes of fiscal and monetary policy accounting in turn for the permanent crisis of a balooning national debt and a persistent deficit in our balance of trade. Fortunately, the blunders of past taxation can be corrected. Something surely should have been done sooner, but it is never too late to abandon a road that leads only to disaster. With a corrected view of tax policy, it is possible to do much more than reduce the deficit, it is possible to eliminate it entirely, and soon. It is also possible to wipe out the national debt without confiscatory taxes or inflation. All it takes is common sense and good intentions wed to bi-partisan action. That is the rub! Can the American people hope for sensible action in the national interest at the expense of numerous powerful special interests?

I don't have the answer to that, but I suspect that if correct tax policy is not soon undertaken, eventually the only positions left open for many members of this august house will be before the firing squads of an irate populace.

Federal taxation is of two main types depending on the incidence of the tax. First, there are the taxes designed to take some dollars from one group of citizens to provide pensions, medical aid, and salaries for other citizens. These taxes generally fund entitlements or transfer payments. Taxes on payrolls, personal incomes, alcohol and tobacco generally fall in this category, and in a well planned tax system, all entitlements and transfer payments, including Veterans' cash benefits, civil and military payrolls, and welfare payments will come solely from taxes on personal incomes. Second: there are taxes designed to raise funds to pay for purchases of goods from the private economy. These purchases are in fact excises on national production and so should be paid for out of excise taxes and tariffs. Furthermore, a well designed tax with an economically sound incidence on the economy will not tax personal incomes to provide the funds for armaments, public works projects and agricultural subsidies. I shall explain why this is necessary a little later on.

Let's turn now to consider the proposed flat tax on incomes, a tax whose time is here. What kind of a flat tax is appropriate and fair? Let's not forget that wages are already subject to a flat tax, one of approximately 15%. This is called the Social Security Tax, but it is a tax on personal income whatever it is called. However, it is a tax that falls only on small and medium sized incomes so it not a fair tax on income lest one considers that those with small incomes will gain more in the long run from the tax than those with higher incomes. This is true to an extent, but many who pay Social Security taxes receive nothing back, and most future recipients will get back much less than they will put in. Worse, the Social Security tax is a double tax! The Treasury spends the money as fast as receipts from wage deductions are received. Then years later the Treasury must tax the wage earner again to pay off the T-Bonds which the Treasury issued against the tax receipts in order to provide benefits. This kind of a tax is a disaster! It raises the cost of doing business to an excessive degree, it vastly reduces employment opportunities, and by putting a financial burden on business to fund the Treasury's General Revenue, it curtails investment capital and causes rising interest rates.

Gentlemen, the Social Security Tax must go! What is to replace it? The flat tax, on incomes, of course. How can this be done? How will present Social Security benefits be financed? Here's how. Approximately 20% of the National Income is accounted for by federal payrolls, including certain partially subsidized payrolls of defense industries, the Post Office, railroads etc., by Veterans payments and Social Security payments, by federal payments to the medical and health care professions to care for aged and indigent patients who are under insured or uninsured; and by payments to many others including lawyers who provide basic legal services for indigents. Now, as subsidized payrolls, public servants, and entitlements take about 20% of the National Income, the flat tax on total personal income must be 20%. This may seem high when applied against the income of a part time laborer earning perhaps $5000 a year, but Gentlemen, remember the Social Security tax is already 15%, so it is not all that great. Besides, a wage earner with an income of $5000 is probably (very probably) the recipient of thousands of dollars of hand outs for food stamps and rent subsidies, so he is not hurt too much. Now why a flat tax? Because it is easy to collect. Every business paying wages, will know it should deduct 20%. Now, since Corporations are owned directly and indirectly by individuals, corporate income should be taxed 20%, also. This will eliminate the double taxation of dividends since 20% will be collected from the corporation whether paid out as dividends or retained as capital and surplus. Taxing corporate income at the same rate as direct personal income recognizes the fact that corporations are now used by many individuals just to avoid taxes on personal incomes. Whether one incorporates or not should not have to be a tax decision.

As to interest, if interest is paid to individuals it will be taxed 20%, the same as a wage. If paid to a business, it will not be taxed because a business will pay a 20% tax on income after all reasonable and necessary expenses. (An individual receiving interest for which the individual incurs sizeable expenses of management has the option of setting up an investment business if he considers the costs of doing so warranted).

Because all taxes on wages, salaries, dividends, business profits, and interest will be paid by the business, no income tax need be paid by individuals. A flat tax will not impact on individuals. Think of the simplicity of collecting such a tax? There will be no need to harrass wage earners, stockholders and ordinary citizens. The IRS can direct all of its attention to collecting taxes on income at the source. It will not be necessary to collect a tax from a stockholder or wage earner if the business pays his tax. The individual taxpayer will lose all incentive to hunt up or set up abusive tax shelters, phony charities, trusts, foreign corporations, etc. (Yes, foreign corporations should also pay 20% on all US generated income, including dividends and interest). With a simplified equalized sensible tax on income, the Treasury will not have to fund a deficit with foreign funds, much of which is really the income of Americans who have been given an incentive to send Money overseas in order to shield it from excessive rates imposed by the present income tax.

Now what about deductions? There should be none! Not even interest on home mortgages. (Why should those well enough off to afford a home mortgage deserve a tax deduction denied to those who have to pay a landlord's interest and taxes)? I suppose interest on municipal bonds will continue to be tax exempt since the courts have held it so. But at 20%, the tax saving by purchasing municipals will not be so high as it is now and may result in more diverse investment by those with very large incomes, thus generating a new source of taxable income.

What about the charities? Will they suffer if no deduction is allowed for contributions? I very much doubt that charities will suffer. On the contrary, they should benefit. Most large charitable contributions are made by rich and well to do taxpayers. If the maximum tax on such incomes is 20%, there will be a lot more income for the rich to give away. As to the poorer taxpayer, he gives such a small part of his income on average to charity that it constitutes but a small dent in the standard deductible. Why should anyone expect a church goer, a member of the Nature Conservancy or Audubon Society to stop giving just because he gets no deduction? Besides, with the exception of the Red Cross, Salvation Army and a few other welfare agencies and schools, most charities serve no real federal purpose.

If the Government provided incentives for citizens to join the Red Cross with, say, a $20.00 membership, it would do more to help fund disaster relief activities than it does now by permitting a tax deduction. Such incentives could take the form of government subsidized flood insurance, or free emergency ambulance services, available only to members of the Red Cross. While on this subject, why not use incentives (other than cash) to man the National Guard and militia? Incentives could be a right to purchase subsidized small arms, tents and equipment, also college loans, medicaid, etc. would go only to those willing to join the militia or to their dependents. Why should Government benefits go to everyone? Only those who serve in some worthwhile capacity should get Government benefits. All others should get charity, not entitlements. Also, only members of the militia should be allowed to possess arms. And like the Swiss, they should own their small arms.

Let's turn now to the kind of taxes to fund arms purchases, public works, roads and agriculture subsidies. Here, the Government takes goods from producers and importers for Public purposes. Take building materials, for example, to build barracks, forts or public works. How should we pay for these? Well, by the Government deciding it needs 15% of the cement, asphalt, bricks, and lumber, 20% of the aluminum or steel. it has already caused a domestic cost increase in the economic cost of those materials because of Government's impact on the domestic supply-demand equation for the particular goods. Other things being equal, and ignoring marginal utility factors for the moment, an increase in Government's demand for steel will cause a corresponding rise in the cost of domestic steel. Now this cost or price factor is the same whether steel is taxed, expropriated or paid for out of general revenues.

Since the immediate effect of a 15% Government demand is a 15% price increase, why not put an excise directly on the product needed by the Government to be paid in cash or kind. What I'm saying is that the Government's demand for a physical commodity is itself the tax on the commodity. This tax on a commodity is not substantially avoided by a tax on high incomes of citizens - the price still goes up for a commodity, no matter that Rockefeller pays for all of the Government's share. Rockfeller's purchase on behalf of the Government increases the price of steel to the builders of office buildings as much as if the steel were subject to an excise tax. True, imports of tariff-free steel could prevent a rise in domestic steel prices, but at the cost of American jobs and of greater balance of payment deficits. Therefore, a 20% excise tax on domestic steel must be matched by a 20% tax on steel imports. This is obvious. What is not obvious is that we have been taxing domestic steel with Government demand but not taxing foreign produced steel. Instead, we have tried Quotas. This has to a small extent prevented all of the steel price rise that an excise tax and tariff would generate, and yet the Government gets no steel from the general price rise, instead it pays for its steel by borowing from foreign banks and oil bandits, and it still has to pay more for the steel, too. In the meantime domestic steel is produced at a loss.

Now there are some products, such as military aircraft, nuclear and conventional arms for which no excise tax can suffice to meet the Government's demand. It's one thing to tax General Motors 5% for 5% of its motor vehicles, but can one put a 60% excise on Boeing or General Dynamics to pay the Governments's share of the submarine and aircraft production? Obviously not! So how do we go? Certainly not with a general Added Value Tax. This newly favored tax idea would be another economic disaster. It would raise the prices of all products, even disable our foreign trade and economic recovery, perhaps irreversibly. First why tax underwear with a 15% Value added tax to pay for arms? The Government's demand for textiles is small. Such a tax would only put America's domestic textiles at a further disadvantage to foreign produced textiles. Look at the lagging economies of the European Common Market! Why haven't they benefited from our prosperity and our increased imports of their goods? Gentlemen, the culprit is the Common Market's Value added tax! The right name for this is the Price Inflation tax. Another idea which is gaining favor with members of the "confused school of economics" is the notion of taxing consumption rather than incomes. Well, if we were on a full war economy this might be necessary to an extent, but a tax on consumption to encourage saving (??) is worse than futile. The higher cost of consumer goods will consume consumer savings, also! Besides, with appropriate taxes appropriately levied, it will not be necessary to increase savings just to fund Government Debt as is now proposed. So how do we pay for our munitions? Well, the cost of building a missile or bomber is the sum of its component parts. The chemicals and metals going to the armament are provided by the Government out of the materials acquired through its excise tax on the producers of those items. Likewise services such as energy and communications are Government supplied out of its excise on those products to the same extent those services are incorporated in the production of the B-1 or Missile. The rest is payroll. If 60% of the payroll of General Dynamics is a cost of making weapons, the Government pays for, or subsidizes, the payroll to that extent, but only if payrolls are not inflated beyond equivalent military and civilian pay. Excess payroll costs can be met by General Dynamics out of other sales and sources of income. In other words, if we fund our defense suppliers in the same way we fund our arsenals, the flat tax on personal income together with reasonable excises on production will provide all necessary defense procurement revenues.

Lastly, I must return to the flat tax again to meet possible criticisims that may be leveled against it because it supposely could not fund Social Security Benefits for current recipients, or because it would fall heaviest on the poor.

As to the impact on the poor: a flat tax could be less burdensome than the present tax system. This is because if future and present Social Security benefits are replaced by IRAs, we begin by eliminating the double tax on incomes which the present Social Security Tax imposes. We also eliminate the enormous interest burden which Social Security Bond investments now impose on the Treasury. By eliminating the deficit with a flat tax (free of deductions) augmented by tariffs and excises to pay for commodities and utility and transportation services, we assure that funds paid into IRAs will be used to buy stocks and bonds in American enterprises, to fund mortgages and other revenue producing investments instead of politicians' boondoogles. It is my suggestion that the first $2,000 of a wage earner's flat tax on income be paid into his IRA (not into Social Security). For married couples the first

$4,000 of flat tax will go into IRAs (even if only one spouse has income). Hence, for all practical purposes any single taxpayer earning $10,000 or less (married couples with $20,000) pay no tax). He's just forced to save for his old age. How's that for a deduction? Politically it should be a politician's God send-no tax, only savings on the low paid wage earners. The flat tax, twenty percent on all incomes (after the IRA contribution) will suffice to pay for all Government payrolls, cash benefits to Veterans, medicare, medicaid, and payroll subsidies to defense suppliers, etc. And Nobody is overtaxed at 20%! The poorest not at all. Gentlemen, how can you pass up a flat tax? Now, some may say that really large incomes should be taxed more than moderate incomes. But what would be the economic result of such a tax policy? First, higher salaries would have to be paid to top executives by business because those executives would pay higher taxes. The really huge incomes of those investing in Municipals, Bond and Mortagages, if taxed at a higher rate would lead to higher interest rates, or of funds transfer to tax havens to avoid the higher tax. (Oh, it might be economically desirable to add a 5% surtax to incomes over $50,000 or $100,00 and allow offsets for verifiable charitable contributions. This might allay fears of those who fear a decline in charitable giving if taxes are lowered on high incomes).

High incomes are not necessarily bad. They stimulate initiate, they support many service industries that would otherwise fade away. Big spenders help support an army of retainers with limited skills as well as of the arts. What a sad, dull place it would be without a bevy of millionaires to be entertained by, and to entertain, the rest of us.

As for funding the retirement payments of already retired Social Security beneficiaries who have had little time to build up an IRA nestegg, what is the solution? Gold is the answer! The U.S. has a huge idle gold stock which is earning nothing. It should be put to work. Here's how. Convert 150 million ounces (figuratively) into 10 ounce Gold Bars or Medallions. (Certificates could be issued for most Medallions). Each Medallion would represent $100,000 of Government debt. Hence, the 150 million ounces in Medallions equals 1½ trillion of Government debt (including Social Security holdings of the debt). These Medallions held in ordinary hands, are worth whatever 10 ounces of gold is worth on the market. But, if a Medallion is deposited in a depository institution, it enables that institution, bank, S&L, credit union, trust, etc. to extend credit to the value inscribed on the Medallion. Such Medallions, (or their certificates) would comprise the reserves of all deposit (or credit extending) institutions. Deposits, other than currency in the vaults or tills, would no longer be reserves for new credit. Even currency would be backed by Medallions. A bank or S&L would take a Medallion or certificate from a depositor and issue a CD on which it would pay interest. The bank could then extend deposit credit against the Medallion. If one bank's deposit credits should flow to other banks in greater degree than deposit credit would be received from other banks, such bank would have to rent new Medallions from The Federal Reserve or acquire them on the market out of capital and surplus, or else reduce its deposit credits. With Medallions providing credit reserves, the banking system as a whole could not inflate credit unless the Government issued new Medallions. A fractional reserve system, such as we have now permits inflation of the money supply beyond real credit needs. (Potentially about 5 or 6 times the National Debt). Sufficient Medallions, or shares thereof, could be issued to Social Security beneficiaries to provide them with a deposit institution funded annuity equivalent to their existing Social Security benefits. Younger Social Security contributors would receive back their total deposit in the Social Security Fund (together with accrued interest) in the form of Medallion certificates or fractional shares which would be added to their IRAs. Government Debt could then be converted into reserves supporting productive deposit credit instead of tax eating interest bearing Government bonds which are becoming an intolerable and unmanageable drain on tax revenues.

Some may think this proposal too good to work. A skeptic may ask - If a bank pays the depositor of a Medallion 6% interest on his CD, and lends $100,000 out at 8% to a borrower, what if the borrower or his payees redeposit the credits in the bank? If so, the bank will have to double interest rates just to break even, won't it? NO! Simply because it won't work that way. A bank cannot relend redeposited credits drawn on itself because they are not Medallion deposits. A depositor of credits can get interest from the bank only by using the redeposited credits to buy shares of a Medallion held by someone else. Since the banks will generally have a supply of their own Medallions, and depositors' Medallions ready to exchange for cash or deposit credit, It should not be necessary to borrow Medallions from a Federal Reserve Bank very often.

The reason the present tax system works to augment inflation rather than to balance budgets is because the incidence of taxes is such as to encourage waste. Once, in a future time, when business finds that Government demand for its product will lead to higher excise taxes, business will no longer strive mightily to sell surplus products to the Government - it will just give them to the Treasury. Also, when individuals all pay the same proportional tax, none will seek "benefits" that they expect someone else will pay for. A fair and equitable tax system will encourage citizen self-reliance, initiative and responsibility. It will also free politicians from the persistent pleadings of selfish interests. Our legislators can again become statesmen instead of partisans endeavoring to patronize a nation of tax serfs.

All that is necessary is common sense to provide the solution to the quagmire threatening to engulf us all. USE IT NOW BECAUSE IT IS PAST TIME TO MOVE! AHEAD LOOMS THE FLOOD!

Thank you very much.

Grant R. Sykes

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August 9, 1984

Roderick A. DeAment, Chief Counsel
Committee on Finance
Room SD-219
Dirksen State Office Building
Washington, D.C. 20510

Honorable Senators, Senate Finance Committee:

RE: The scheduled hearings on major revision of the tax system on August 7 and 8, 1984.

As you plan and discuss current and new tax laws we at Manhattan Christian College, a full four year accredited private college, want you to be aware that private colleges are dependant upon charitable contributions as our life-line for existance.

The long-established congressional policy of encouraging charitable gifts by offering tax incentives to donors has been and will continue to be of utmost inportance in providing the essential funds for our work.

We urge you to continue to provide the long-established program of tax incentives to donors for charitable gifts to worthy work in any new tax law you may recommend from your committee.

Respectfully,

Allen Ellas

Allen Ellas
Director of Planned Giving

AEE:aje

STATEMENT OF
NATIONAL ASSOCIATION OF HOME BUILDERS
BEFORE THE
SENATE FINANCE COMMITTEE
ON
PROPOSALS TO REVISE THE FEDERAL INCOME TAX

August 7, 1984 and August 9, 1984

Washington, D.C.

Mr. Chairman and Members of the Committee:

My name is Peter Herder and I am a homebuilder from Tucson, Arizona. I appear here today on behalf of the more than 125,000 members of the National Association of Home Builders (NAHB), of which I am President. NAHB is pleased to present its views on revision of the tax system.

NAHB is concerned that many of the tax proposals currently being considered reduce complexity at the expense of economic efficiency and fairness and could lead to shifts in national policy. Tax incentives are a major component of housing policy, especially since direct housing subsidy programs have been virtually eliminated. It should be noted that NAHB has supported this policy direction as part of a general approach to reduce growth in government spending and encouraging private sector capital formation. It has been our belief that free market incentives are more effective than other alternatives.

Because of the effect of tax policy on housing and housing policy, tax revisions should not be viewed in isolation from other changes in housing policy and programs. Tax policy is of major importance to those who construct housing, to those who finance housing, and to those who eventually reside in it. We need a consistent tax policy which reaffirms our national commitment to affordable, quality housing -- both for homeownership and for rental housing. A consistent policy of support for decent housing and homeownership has been a national commitment for more than fifty years.

The homeowner's mortgage interest deduction is the most visible evidence of this commitment. Any modification of the homeowner's mortgage interest deduction would have a devastating effect on both the housing market and the economy. We believe very strongly that this provision of the tax code should remain.

The effect of tax policy upon housing extends to all elements of the housing industry. For example, the tax portion of the 1984 deficit reduction package recently agreed to by the House and Senate Conferees will amount to approximately an $8 billion tax increase for housing and the real estate industry. The average taxpayer and businessman has little knowledge of obscure tax code provisions involving partnerships allocations, like-kind exchanges, original issue discount accounting, and the capitalization of construction period interest and taxes. Yet each of these changes will increase taxes and the cost of capital for housing and ultimately the consumer, through higher rents or purchase prices.

NAHB is reviewing various tax proposals, but as we look at them, we need to keep in mind certain basic principles.

° Homeownership should be encouraged. Tax changes should not increase the cost of housing, particularly for those who are just entering the housing markets. Tax changes should maintain existing property values and should not result in diminishing the value of homeownership -- which is often a family's major investment. Homeownership is also important to to the community. It provides for social and political stability.

° A suitable framework for the evolution of the system of housing finance should be maintained. Dramatic changes are occurring in the way capital is accumulated to finance homes and rental housing. The marketplace has been able to utilize the existing tax framework to adjust to new trends which have developed. While far from perfect, existing tax rules should not be revised in such a manner which would jeopardize the evolutionary growth of the mortgage finance system and the important role which current players including FNMA, FHLMC, GNMA, and a variety of private financial institutions play.

° Incentives for capital investment, particularly for the construction and ownership of rental housing, should be maintained. Special consideration should be given to low income housing needs. We face a shortage of rental housing. New construction based upon existing tax provisions will not overcome the rental housing shortfall. Incentives directed toward capital formation for rental housing, particularly ACRS depreciation allowances and the use of partnerships as a means of capital accumulation for investment in rental housing, should be maintained and strengthened.

° The tax system should foster savings and capital formation. Economic productivity and growth requires private capital formation. Incentives to save and invest should remain as an integral part of the tax system and new savings incentives should be considered.

° Frequent changes in the tax law should be discouraged. Tax changes create investment uncertainty. Future changes should attempt to minimize potential market dislocations which the changes could create. Certainty which permits long-term planning is essential.

° Reform should facilitate tax compliance with an eye towards deficit reduction. Reform for the sake of reform is not enough. While the current law is far from perfect, for many taxpayers who use the standard deduction, it is relatively simple. It does promote desirable economic and social goals. It is relatively fair in terms of being progressive. Any change to a true flat rate tax will place a higher tax burden on low and middle income taxpayers unless appropriate exceptions are made.

FEDERAL DEFICIT

Although the Congress is moving toward enactment of a "down-payment" on the federal deficit in 1984, the need for additional reductions remain. NAHB shares the view of most political leaders and economic experts of this country:

Budget deficits of the magnitude we are experiencing, and are likely to experience through the remainder of the decade, require a bipartisan plan. Last year NAHB developed a grassroots campaign focusing on the serious effect deficits have on continued economic growth and recovery. Deficits are indeed America's "ticking time bomb."

Deficit reduction should not, however, be a signal to increase taxes at the expense of housing. The housing and real estate industry in the recent tax bill paid its "fair share" and arguably more than its fair share in deficit reduction. The 1984 "down-payment" raised approximately $8 billion in revenues on the real estate industry through 1987. This is about 15 percent of the total revenues raised. Future deficit reduction should be broad-based and should not place such a heavy burden on housing.

TAX POLICY AND HOUSING POLICY

In light of the previously discussed principles, we want to reiterate the importance of tax policy as it relates to homeownership, mortgage finance and rental housing.

Homeownership

Incentives for homeownership should be continued and homeownership should be encouraged. The most obvious incentive for homeownership is the mortgage interest deduction. Any system which eliminates the mortgage interest and property tax deduction would substantially raise the cost of housing for many households. The mortgage interest deduction makes ownership of a home affordable for many Americans. Take for example, a married couple with two children filing a joint return. Using the tax rates effective July 1, 1983, and assuming a family income of $35,000 per year, the mortgage interest deduction helps this family qualify for a $70,000 house. Without the mortgage interest deduction, the same family could qualify for only a $53,000 home. With the average price of a new home in the $70,000 range, the mortgage interest deduction becomes an important element in permitting ownership of a home.

While most proposals being considered retain the mortgage interest deduction, the effect of a dramatic reduction in tax rates upon the deduction should also be considered. From a tax point of view, the value of the deduction decreases as marginal tax rates decrease. Therefore, this assistance for homeownership diminishes as marginal tax rates decline. Presumably, the reduced value of the deduction will be compensated for by provding lower tax rates, thereby giving most taxpayers additional capital to use for a home purchase. This, however, may not be the case and special provisions for homeownership may be necessary.

Not only could housing affordability suffer through changes in the mortgage interest and property deductions, but property values could also diminish. This could also could occur with a dramatic reduction in marginal tax rates. Such action would adversely impact the savings of many Americans who view homeownership as their major investment. Care must be taken to avoid such a result.

Housing Finance

The present housing finance system is undergoing tremendous change. Tax revisions should point toward improving the access of housing finance to the capital markets. Current housing finance delivery systems should not be jeopardized in exchange for new or untried approaches.

The growing interest of financial markets in mortgages as investment is an important development for housing. The tax laws should provide a workable framework to permit new approaches while retaining established methods of housing finance.

The following points regarding mortgage finance should be considered in reviewing the tax law.

- Mortgage-backed securities are a principal tool for raising mortgage money in capital markets. The tax law should encourage the growth and development of mortgage backed securities by federally related and private entities.
- Builder financed home purchases utilizing the installment sales provisions of the tax code are an important means for builders to provide the capital necessary for a home purchase, similar to current techniques for financing automobiles and appliances. This important financing tool should be permitted to continue.
- Tax exempt bonds issued by state and local governments continue to be an effective means of promoting the development of moderate income rental housing and providing homeownership opportunities for first-time homebuyers. This year, Congress reaffirmed the essential tax exempt bond-financed housing programs.

- To meet the mortgage capital needs of the eighties and beyond, it is essential to lower tax barriers to foreign investments in the United States.

Rental Housing

Multifamily housing is an essential aspect of any housing policy. NAHB anticipates a rental housing shortfall of more than 100,000 units per year over the next decade. Incentives for continued investment in multifamily housing are necessary. Yet, the history of recent tax legislation affecting residential structures has been a progressive diminution of the tax benefits associated with this type of investment. The requirement that construction period interest and taxes (IRC Section 189) be capitalized was introduced in 1976. No industry other than real estate construction is required to capitalize interest. Residential real estate also does not have the advantage of the investment tax credit, except for the rehabilitation of historic structures. In addition, the alternative minimum tax often affects capital gains associated with real estate investments more than it affects investments in other types of assets, particularly corporate equities or bonds.

Your future decisions in this area are especially important because the focus for housing policy has shifted towards the tax writing committees. Federal housing production programs have been virtually eliminated. For example, since 1980, federal budget authority for housing assistance has declined from $27.8 billion to an estimated $8 billion in 1984. (See Appendix A.)

From an investment point of view, rental housing has often not been attractive. Intensive management to maintain an adequate income stream is necessary. Costs of maintaining rental property have increased considerably in recent years. In addition, income generated from rental property is lower than for other types of property.

Residential rentals do not generally carry CPI inflation increases, and the income of residents can only support a certain level of rent. Therefore, market rents generally do not create an income stream which is competitive with other types of investments. In addition, rent control in many jurisdictions has kept rents at below market levels.

As a result, tax revisions should establish special incentives for rental housing to permit it to be competitive with other types of investments. Tax changes should not have the effect of driving capital away from residential housing at a time when more, not less, capital is needed. Otherwise, additional direct government subsidies will be necessary.

CONCLUSION

In conclusion, the American economy as well as the housing industry will face severe challenges over the next several years. Tax revisions must maintain a commitment to affordable, quality housing. Housing - both owner-occupied and multifamily - are a principal source of economic growth. This commitment is more than economics; it extends to providing every American with a stake in their own community and our nation.

Deficit reduction, tax simplification, and affordable, quality housing must be given equal priority in any tax revision proposal.

Changes should consider the implications for homeownership, housing finance, multifamily housing, savings and capital formation, and should foster investment certainty and long-term planning. NAHB is studying the implications of various tax proposals but has not reached a definite position on the alternatives. We look forward to working with your Committee and the Congress on this important issue.

Thank you for the opportunity to present our views. I would be happy to answer any questions you may have.

APPENDIX A

BUDGET AUTHORITY FOR HOUSING ASSISTANCE

($ BILLION)

	1980	1981	1982	1983	1984
Budget Authority	27.8	26.1	13.9	8.9	8.0*

* Estimate

Source: Low Income Housing Information Service

OREGON
BANK

Dennis H. Miller
Senior Vice President

August 3, 1984

Roderick A. DeArment, Chief Counsel
Committee on Finance
Room SD-219
Dirkson Senate Office Building
Washington, D.C. 20510

RE: Tax Reform Options Hearings
August 7th & 8th, 1984

Dear Friends:

As a member of the Board of Directors of the National Easter Seal Society, and Chairman of the Board of Directors of the Easter Seal Society of Oregon, I have had a first hand opportunity to see the important work that is done by non-profit agencies in our country. Demands for these services would likely fall upon public revenues if these organizations did not provide them.

As an example, Easter Seals provided major services to over 750,000 children and adults around the nation during the year covered by our last annual report. These included therapy, medical equipment, residential camping, special recreation programs, and a wide variety of other assistance. This required the expenditure of more than $142 million. Since Easter Seals is only one of a great many charities, the public benefit from the non-profit sector is apparent.

I believe that the amount of voluntary financial support for public charities, and other non-profit agencies, would be substantially reduced if federal tax incentives for donations were eliminated or reduced. While I am generally in favor of tax reform and an advocate of the flat rate tax, I would urge that any new tax law continue to provide incentives to donors.

Sincerely,

Dennis Miller

Dennis Miller

The Oregon Bank
1001 S.W. Fifth Avenue
P.O. Box 3066
Portland, Oregon 97208
503/796-3801

STATEMENT OF
ELLIOT L. RICHARDSON
TO THE
SENATE FINANCE COMMITTEE
HEARING ON MAJOR TAX REFORM OPTIONS
AUGUST 7, 1984

The time has come for a major overhaul of the federal income tax system. I strongly support President Reagan's State of the Union call for a "simpler and fairer" tax code. Efforts must be focused on simplifying the tax code, closing loopholes, improving taxpayer compliance and broadening the tax base so that taxes can ultimately be lowered. My comments today will be limited to the tax structure -- the skeleton on which we hang our substantive tax laws.

The present tax structure is the result of the myriad of interests -- special and public -- imposing their wishes on Members of Congress. Never in our history has the system been so difficult to understand and comply with. During the course of the 71 years of our "modern" income tax system, we have not been at a more critical time than today. The situation has reached grave proportions, with dramatic implications for our economic system. Our tax structure has contributed to the over-$200 billion deficit and is now threatening to cripple our economy. Only through judicious spending cuts and tax reform can we begin to solve this critical problem.

The sheer complexity of our tax system has resulted in untold loss of tax revenues. Entire segments of the economy go untaxed. The billions of dollars in sales in the underground economy, for example, go completely untaxed, which forces otherwise legitimate businesses, in an effort to compete, to cut corners on their own taxes. This causes tremendous erosion in both revenues and vitality in the economy.

Beyond the economic implications, however, is the loss of faith by the American people in a fundamental component of their government. It was Plato who wrote that "when there is an income tax, the just man will pay more and the unjust less on the same amount of income." Widespread injustice in any form, including in the tax system, cannot be left alone to grow in our country. We must embark on a vigorous campaign to ensure that every portion of the economy pay its share, and that the share it pays is fair.

Major reform of the tax system is the place to start. We cannot ask people to pay their fair share of taxes if they do not understand the system, so tax reform must also be perceived as fair.

Whatever one's views on the basic direction the American tax system should take, we can all agree that simplification is essential to a successful system. Regardless of the option that receives final approval, the clean slate offered by a significantly streamlined tax code must be used to create a system that enhances, rather than inhibits, our ability to collect efficiently the revenues required to run an effective and responsive government.

I do not believe, however, that a strictly "flat" tax is the option to pursue. While it is the epitome of a simple system, it suffers by placing an undue burden on low and moderate income taxpayers. A measure of progressivity is essential if we are to retain fairness in the search for simplicity.

Simplification, though, is but the first step in what must be a strong effort to improve taxpayer compliance. It will help increase voluntary compliance; we must take active measures, however, to require compliance, however involuntary, from those who are making an effort to avoid their taxes. A recent Congressional Budget Office report indicates that over 12 dollars in tax revenues can be raised by every dollar spent on increased audit and collection services. Simplification can increase the returns on enforcement dollars.

The fairest tax system, in my view, is one that calls on each individual and business to contribute their share of the country's needs while, at the same time, maximizing the ability of the economy to expand and grow. Such a system can only be created when our existing system is changed to provide incentives for the free market to flourish. The public interests must hold sway over special interest.

As I have stated in other forums, I believe, as do the distinguished members of this Committee, that reduction and elimination of our budget deficit is the single most important economic issue of the day. Prudent tax reform and simplification can go a long way toward meeting that goal.

Thank you for allowing me to express my views, and I wish you every success in dealing with this critical area.

ALAN L. RAUCHMAN
ACCOUNTANCY CORPORATION
TWO CENTURY PLAZA
2049 CENTURY PARK EAST, SUITE 1350
LOS ANGELES, CALIFORNIA 90067
(213) 552-1450

August 8, 1984

Mr. Roderick A. DeArment
Chief Counsel Committee of Finance
Dirksen Senate Office Building, Room SD-219
Washington, D.C. 20510

Re: Hearings on options for a
major revision of the tax system
on August 7 and 9, 1984.

Dear Sir:

Having learned of these hearings from the Standard Federal Tax Report Number 31 published by Commerce Clearing House, Inc., I am submitting herewith my suggestions for revising the tax system that this publication indicated you would welcome receiving from interested parties.

1.) Establish a national sales tax or value-added tax and eliminate the withholding of Federal income tax and FICA taxes from employee paychecks.

The tax should be set at a sufficient rate (15-20%) to sustain the daily cash flow of revenues to run the government and pay down the national debt. To eliminate the burden of this new sales tax, the sales tax would be used as a credit for taxes paid by U.S. Individual Return Form filers in place of withheld payroll taxes. The individual filer would prepare his annual income tax return in the usual manner but would also have to include the FICA tax liability for wages received using a schedule similar to the one used to report self-employment income. The income tax calculation should be structured to eliminate the regressive qualities of the national sales tax.

The taxpayer should have the option of using the actual amount of sales tax paid or using established sales tax tables to determine his tax paid credit based on net taxable income as presently defined. The structure of these tables would be similar in design to presently used optional sales tables to determine deductible sales taxes on Form 1040, Schedule A. Further, additionally modified tax credit tables could be designed for short form filers. The balances of taxes owed or overpaid would be settled in the manner presently in use.

Remittance of the national sales tax collections would have to be as prompt as present payroll tax collections. Employers would still have to report and remit their share of payroll taxes is the usual manner.

The administration of the national sales tax should include some form of resale credit allowance at each level of distribution so that only the last user would pay the tax in full.

I believe that the administrative costs for the national sales tax would be offset by a reduction in costs resulting from the suggested elimination of payroll withholding taxes. Further, wage earners would have larger paychecks giving them a little more flexibility in handling their personal affairs.

1.) continued
The national sales tax could increase government revenues by tapping the underground "cash" economy that so many believe escapes all taxation and that thrusts the tax burden on taxpayers of record.

Taxpayers living outside the United States could not use any national sales tax credit.

2.) Increase the IRA maximum allowance for Individual Income Return filers filing joint returns.

Since Social Security benefits have become increasingly inadequate because of inflation and the growing longevity of our population, it should be evident that the present IRA maximum is also inadequate. People sould be encouraged to save for their retirement and retired people should not have to be so dependent on the U.S. Congress for Social Security benefit increases.

This is not a tax give-away, as any increase in the IRA allowance would reduce net taxable income with a corresponding decrease in the national sales tax credit, previously mentioned.

3.) Repeal the dividend exclusion of the Individual Income Tax Return and tax dividends and interest at their fully reported amounts.

Income that is received should be income that is subject to tax. If the taxpayer wished to avoid income taxes on interest he should be able to put more in the IRA plan as suggested.

4.) Corporations that file U.S. Corporation Income Tax Returns should be permitted to deduct from taxable income all dividends paid to U.S. taxpayers furnishing the payers of dividends with either social security numbers or employer identification numbers and sworn statements affirming that they are U.S. taxpayers.

This suggested deduction eliminates double taxation of the same revenue and the payees of these dividends would be taxed as explained herein. Corporations would still be required to furnish the payees with annual report forms (1099) indicating the nature and amount of these dividends.

In those cases where payees of dividends do not furnish the aforementioned identifications and sworn statements, it may be presumed that the dividends might escape taxation and therefore could not be deducted from the corporation's taxable income.

Sincerely,

Alan L. Rauchman

Alan L. Rauchman

ALR/tab

SAINT JOSEPH
MEDICAL CENTER
FOUNDATION

Frank J. Mayo
Vice-President

August 6, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Hearing Date: August 7 and 9, 1984
Subject: "Options for a Major Revision of the Tax System"

Dear Sir:

In the considerations which the Senate Finance Committee will give to changes in our tax laws I draw to your attention the following:

I. There is a strong concern on the part of this and many other charitable organizations that in any major revision of our tax laws, the continued provision of tax incentives to our donors is of critical importance.

II. I take no position on behalf of our Foundation as to whether the current tax laws should be retained or whether a flat tax is better than a VAT tax. However, any new law should continue the long-established Congressional policy of encouraging Charitable Gifts by giving tax incentives to donors.

Buena Vista & Alameda, Burbank, California 91505 (818) 840-7991
PARTNERSHIP FOR THE FUTURE

III. Tax-encouraged Gifts are vital to the continued solicitation of current outright and deferred gifts to this Foundation. Any tax law which discourages giving here would have the effect of increasing the cost of medical care substantially.

Sincerely,

F.J. Mayo

Frank J. Mayo
Vice President
Saint Joseph Medical Center Foundation

FJM:bv

cc: Arthur S. Collier, President
SJMC Foundation

Seidman
&
Seidman
BDO
15 Columbus Circle, New York, New York 10023 (212) 765-7500, TLX 661 903

REMARKS OF MARIO P. BORINI, PH.D., CPA
NATIONAL TAX DIRECTOR, SEIDMAN & SEIDMAN
SENATE FINANCE COMMITTEE TAX HEARINGS
WASHINGTON, DC, AUGUST 7, 1984

THANK YOU MR. CHAIRMAN. MY NAME IS MARIO P. BORINI AND I AM DIRECTOR OF TAX PRACTICE FOR SEIDMAN & SEIDMAN, THE NATIONAL ACCOUNTING FIRM.

I WELCOME THIS OPPORTUNITY TO PRESENT SEIDMAN & SEIDMAN'S VIEWS ON THE INTERNAL REVENUE CODE, AND TO OFFER OUR SUGGESTIONS FOR TAX REFORM. 1985 WILL SURELY BE A BANNER YEAR FOR TAX REFORM, AND THIS COMMITTEE WILL SHOULDER A CONSIDERABLE PORTION OF THE REFORM BURDEN. IN THE PROCESS YOU WILL HAVE TO CONSIDER A RANGE OF ISSUES, FROM RAISING SUFFICIENT REVENUES TO REDUCE FEDERAL DEFICITS, TO ANSWERING THE OVERWHELMING CALL TO MAKE THE TAX CODE FAIRER AND SIMPLER.

MY REMARKS TODAY ARE INTENDED TO CALL ATTENTION TO A PRESSING TAX REFORM ISSUE, BUT ONE THAT MAY HAVE BEEN

OVERLOOKED BY THE MAJOR CONTENDERS FOR TAX REFORM ATTENTION: THE PLIGHT OF SMALL AND EMERGING BUSINESSES.

THE SMALL BUSINESS ADMINISTRATION'S THEME THIS YEAR IS "SMALL BUSINESS MEANS JOBS." AND THE THEME IS WELL-TAKEN. SMALL COMPANIES ARE PEOPLE-INTENSIVE. IT IS ESTIMATED THAT SMALL BUSINESS CREATED MORE THAN 20 MILLION NEW JOBS BETWEEN 1970 AND 1980. IN 1981 AND 1982 ALONE THEY CREATED 2.6 MILLION NEW JOBS. BY COMPARISON, BIG BUSINESS LOST 1.6 MILLION JOBS IN THE SAME PERIOD. CLEARLY, SMALL BUSINESS CONTRIBUTED SIGNIFICANTLY TO THE ECONOMIC RECOVERY WE ARE NOW ENJOYING. AND A RECENT MCKINSEY & COMPANY STUDY FOR THE AMERICAN BUSINESS CONFERENCE ESTIMATED THAT SMALL BUSINESS ACCOUNTS FOR 55 PERCENT OF TOTAL PRIVATE SECTOR EMPLOYMENT. IN THE PRESENT ENTREPRENEURIAL ECONOMY SMALL BUSINESS REMAINS THE SINGLE MOST IMPORTANT FORCE IN NEW JOB FORMATION.

BUT SMALL BUSINESS MEANS MORE THAN JOBS. J. PETER GRACE, WHO HEADED THE PRESIDENTIAL COMMISSION ON GOVERNMENT SPENDING, HAS POINTED OUT THAT SMALL COMPANIES GENERATE 24

TIMES AS MANY TECHNOLOGICAL ADVANCES PER DOLLOAR SPENT AS DO LARGE COMPANIES. AND PRESIDENT REAGAN, IN HIS 1984 SMALL BUSINESS WEEK PROCLAMATION, CALLED SMALL BUSINESSES THE STANDARD-BEARERS OF ECONOMIC PROGRESS AND THE STALWARTS OF THE ENERGIZING FORCES OF THE FREE MARKET.

BUT DESPITE THEIR IMPRESSIVE CONTRIBUTIONS TO OUR ECONOMY, SMALL BUSINESSES NEED HELP. THEY RECEIVED ONLY A 2.8 PERCENT TAX REDUCTION FROM THE 1981 AND 1982 TAX CUTS. INCREMENTAL CHANGES WILL NOT PROVIDE SMALL COMPANIES THE RELIEF THEY NEED TO GROW, PROSPER, AND CONTRIBUTE TO THE NATIONAL ECONOMY. BROADER CHANGE IS REQUIRED IF SMALL BUSINESS IS TO CONTINUE PROVIDING DRAMATIC CONTRIBUTIONS TO THE NATIONAL ECONOMY.

I AM HEARTENED TO NOTE THAT IN HIS 1984 REPORT TO CONGRESS ON THE STATE OF SMALL BUSINESS, PRESIDENT REAGAN ANNOUNCED, AND I QUOTE: "TAX POLICIES THAT SUSTAIN THE CASH FLOW OF SMALL FIRMS WILL CONTINUE TO BE A MAJOR GOAL OF THIS ADMINISTRATION. MORE REASONABLE AND UNDERSTANDABLE TAX

REGULATIONS ARE IMPORTANT AND NECESSARY POLICY GOALS FOR SMALL BUSINESS." ENDQUOTE. SUCH A POSITION TRANSCENDS PARTY LINES. TAX POLICIES THAT SUSTAIN THE CASH FLOW OF SMALL FIRMS HAS TRULY BIPARTISAN APPEAL. AND ONE REASON FOR THIS IS THAT THE NEED IS SO PRESSING.

IT IS PRECISELY THIS ISSUE I WISH TO DISCUSS TODAY: TAX POLICIES THAT SUSTAIN THE CASH FLOW OF SMALL FIRMS. SMALL COMPANIES FACE MANY CHALLENGES SURVIVING THEIR EARLY YEARS TO ACHIEVE PROSPERITY AND CONTRIBUTE TO THE ECONOMY. OF ALL THE CHALLENGES CONFRONTING THEM, CAPITAL FORMATION AND RETENTION HAS THE MOST FAR-REACHING CONSEQUENCES FOR INDIVIDUAL COMPANIES AND FOR THE NATIONAL ECONOMY. IT IS A PROBLEM THAT SMALL COMPANIES THEMSELVES CANNOT SOLVE. IT IS NOT OF THEIR MAKING, AND THE MEANS FOR SOLVING IT ARE NOT AT THEIR DISPOSAL. RATHER, GOVERNMENT ACTION IS NEEDED TO ALLEVIATE THE BURDEN SMALL COMPANIES BEAR. THE TAX CODE MUST BE CHANGED TO ALLOW SMALL COMPANIES TO RETAIN THEIR CAPITAL TO FINANCE OPERATIONS.

AS YOU KNOW, SMALL COMPANIES' CAPITAL NEEDS ARE UNIQUE. START-UP CAPITAL FOR MOST SMALL BUSINESSES COMES FROM THE PERSONAL SAVINGS OF THE OWNER, HIS RELATIVES, AND FRIENDS. INSTITUTIONAL EQUITY CAPITAL IS GENERALLY UNAVAILABLE, LEAVING ONLY TWO SOURCES TO FINANCE OPERATIONS: BORROWING, AND INCOME.

BORROWED CAPITAL, IF AVAILABLE AT ALL TO SMALL COMPANIES, COMES AT AN INORDINATELY HIGH COST: SOMETIMES AS HIGH AS SEVEN PERCENTAGE POINTS ABOVE WHAT LARGE COMPANIES PAY. SMALL COMPANIES IN PARTICULAR ARE SENSITIVE TO A CREDIT CRUNCH DURING A RECESSION, AND ARE ALWAYS PREY TO THE UNCERTAINTY OF FLUCTUATING INTEREST RATES.

FINANCING OPERATIONS WITH BORROWED CAPITAL IS EXPENSIVE, INEFFICIENT, AND RISKY, WITH DEBT SERVICE REQUIREMENTS PLACING A HEAVY BURDEN ON CASH FLOW. AN ECONOMIC DOWNTURN, WITH ITS HIGHER INTEREST RATES AND REDUCTIONS IN CASH FLOW, MAY CAUSE MANY SMALL COMPANIES TO DEFAULT ON LOANS, WITH DIRE ECONOMIC CONSEQUENCES.

INDEED, THE SMALL BUSINESS ADMINISTRATION REPORTED THAT

MANY SMALL BUSINESSES EITHER CURTAILED EXPANSION, VOLUNTARILY DISSOLVED, OR WENT BANKRUPT DURING THE RECENT RECESSION. AND THE DANGER OF BUSINESS FAILURE PERSISTS EVEN IN GOOD TIMES.

THE REASON SMALL COMPANIES ARE FORCED TO BORROW IS THAT A LARGE PERCENTAGE OF THEIR INCOME IS SIPHONED OFF BY THE CORPORATE INCOME TAX. JUST AS SMALL COMPANIES ARE COMING INTO THE BLACK, POISED FOR EXPANSION AND GROWTH, THE CORPORATE INCOME TAX DRAINS THEIR LIFE'S BLOOD. TO COMPENSATE FOR THIS LOSS THEY MUST CHOOSE EITHER TO BORROW OR TO CURTAIL EXPANSION PLANS. NEITHER CHOICE IS CONDUCIVE TO THE COMPANIES' HEALTH. BUT MORE IMPORTANT, NEITHER CHOICE IS CONDUCIVE TO NATIONAL ECONOMIC GROWTH.

BY DEPRIVING SMALL COMPANIES OF THEIR INCOME, OUR TAX STRUCTURE NOT ONLY IMPEDES THEIR GROWTH; IT REDUCES THEIR CHANCES OF SURVIVAL IN AN ALREADY PRECARIOUS ARENA. AND IT PREVENTS MANY SMALL COMPANIES FROM MAKING ANY POSITIVE ECONOMIC CONTRIBUTION THEY MIGHT OTHERWISE OFFER.

TO HELP DECISION MAKERS FRAME A TAX CODE TO HELP SMALL

BUSINESS, SEIDMAN & SEIDMAN HAS PROPOSED A SMALL BUSINESS CONSUMED INCOME TAX. THE DETAILS OF THE PROPOSAL ARE TOO ELABORATE TO DISCUSS IN THE TIME WE HAVE TODAY. BUT I'D LIKE TO OFFER THIS COMMITTEE COPIES OF THE PROPOSAL, AND SUBMIT A COPY FOR THE RECORD AS AN EXPANSION OF MY REMARKS.

UNDER OUR PROPOSAL, COMPANIES MEETING CERTAIN CONDITIONS COULD ELECT A 10-YEAR EXCLUSION FROM THE CORPORATE INCOME TAX. DURING THAT TIME, SHAREHOLDERS WOULD BE TAXED PERSONALLY FOR INCOME DISTRIBUTED TO THEM OR INVESTED BY THE COMPANY IN NON-BUSINESS ASSETS. BUT AS LONG AS THE INCOME FUNDS BUSINESS OPERATIONS, NO TAX WOULD BE IMPOSED.

THIS SYSTEM IS SIMILAR IN NATURE TO A CONSUMPTION TAX, WHICH TAXES BORROWING BUT DOES NOT TAX SAVINGS. SUCH A SYSTEM WAS ELABORATED UPON LAST YEAR BEFORE THIS COMMITTEE BY ACTING ASSISTANT TREASURY SECRETARY FOR TAX POLICY PEARLMAN. BUT WHEREAS A GENERAL CONSUMPTION TAX ENCOURAGES COMPANIES AND INDIVIDUALS TO SAVE, A SMALL BUSINESS CONSUMED INCOME TAX ENCOURAGES SMALL COMPANIES TO REINVEST THEIR INCOME IN

THEMSELVES.

OUR SYSTEM WOULD ALSO REPRESENT A CONTROLLED INTEGRATION OF CORPORATE AND PERSONAL INCOME TAX, WHICH HAS BEEN MUCH DISCUSSED IN RECENT YEARS.

BY RETAINING THEIR INCOME, SMALL COMPANIES WOULD BE ABLE TO FINANCE OPERATIONS, EXPANSION, NEW EMPLOYEES, AND NEW PRODUCTS, WITHOUT RELIANCE ON BORROWED CAPITAL. AND COMPANIES THAT DO BORROW UNDER OUR SYSTEM WOULD BE IN A STRONGER FINANCIAL CONDITION, WITH IMPROVED CASH FLOW. THIS WOULD MINIMIZE THE RISKS NOW FACED BY COMPANIES THAT BORROW IN ORDER TO SURVIVE.

AS WE POINT OUT IN OUR PROPOSAL, THIS SYSTEM WOULD HAVE A MINIMAL IMPACT ON FEDERAL REVENUES. GIVEN THE PRESENT CONCERN FOR THE BUDGET DEFICIT, ALL CARE MUST BE TAKEN TO ASSURE THAT TAX LEGISLATION NOT ADVERSELY AFFECT THE BUDGET-BALANCING PROCESS. AS ACCOUNTANTS WE ARE PARTICULARLY SENSITIVE TO THIS UNDERTAKING.

FEDERAL REVENUES LAST YEAR WERE 601 BILLION DOLLARS.

ONLY 37 BILLION DOLLARS OF THIS TOTAL CAME FROM THE CORPORATE INCOME TAX. AND SMALL COMPANIES CONTRIBUTED ONLY 6 BILLION DOLLARS TO THAT AMOUNT. SO A TOTAL EXEMPTION OF SMALL BUSINESS INCOME FROM TAXES WOULD THEORETICALLY RESULT IN A REVENUE DRAIN OF ABOUT 6 BILLION DOLLARS, OR 1 PERCENT OF TOTAL FEDERAL REVENUES.

BUT CLOSE EXAMINATION REVEALS THAT OUR SYSTEM WOULD NOT HAVE NEARLY SO GREAT AN EFFECT. MANY FACTORS WOULD MITIGATE SUCH A DRAIN. TO BEGIN WITH, SOME SMALL COMPANIES WOULD NOT ELECT TO OPERATE UNDER OUR SYSTEM, AND WOULD BE TAXED AS USUAL. MANY COMPANIES ELECTING OUR SYSTEM WOULD CONTINUE PAYING DIVIDENDS, WHICH WOULD BE TAXED TO SHAREHOLDERS PERSONALLY.

FURTHER, BY ALLOWING SMALL COMPANIES TO CREATE NEW JOBS, OUR SYSTEM WOULD CONTRIBUTE TO FEDERAL REVENUES. EACH NEW JOB REPRESENTS A NEW TAXPAYER AND A MORE VIGOROUS CONSUMER. AND IN MANY CASES IT ALSO REPRESENTS A REDUCTION IN PUBLIC SUPPORT ROLLS. THESE FACTORS COMBINED WOULD SIGNIFICANTLY OFFSET ANY

INITIAL REVENUE DRAIN.

BUT MOST IMPORTANT, OUR SYSTEM WOULD INVIGORATE THE ENTREPRENEURIAL ECONOMY, ALLOWING IT TO PROVIDE ADDITIONAL GOODS AND SERVICES, EMPLOY MORE PEOPLE, AND MAKE YET GREATER CONTRIBUTIONS TO THE NATIONAL ECONOMY.

I UNDERSTAND THAT SENATOR STEVEN SYMMS, A MEMBER OF THIS COMMITTEE, WILL SOON INTRODUCE LEGISLATION BASED ON OUR PROPOSAL. I SALUTE SENATOR SYMMS FOR HIS COMMITTMENT TO FORGING A TAX POLICY SUSTAINS SMALL COMPANIES' CASH FLOW. I URGE THE COMMITTEE TO SUPPORT HIS BILL, AND TO MAKE ITS ENACTMENT A HIGH PRIORITY IN THE 1985 LEGISLATIVE TERM.

IN SUMMARY, TAX REFORM FOR SMALL BUSINESS IS CLEARLY NEEDED, AND LONG-OVERDUE. ANY REFORM SHOULD TAKE ACCOUNT OF SMALL BUSINESS' MOST PRESSING REQUIREMENT, CAPITAL. I URGE THIS COMMITTEE TO CONSIDER A TAX SYSTEM THAT PROVIDES SMALL BUSINESS WITH THE RESOURCES NECESSARY TO ENDURE, TO GROW, AND TO CONTRIBUTE TO THE ECONOMY. A SMALL BUSINESS CONSUMED INCOME TAX, AS I HAVE DESCRIBED HERE, AS ELABORATED

IN OUR PROPOSAL, AND AS WILL BE INTRODUCED BY SENATOR SYMMS, WOULD PROVIDE SUCH A SYSTEM.

THANK YOU.

SPBA SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS
2033 M Street, NW • Suite 605 • Washington, D.C. 20036 • (202) 223-6413

OUTLINE OF ORAL TESTIMONY TO THE SENATE FINANCE COMMITTEE
HEARING ON MAJOR TAX REFORMS - August 7 & 9th, 1984
by Frederick D. Hunt, Jr. , Executive Director
Society of Professional Benefit Administrators

1/ The allotted time is insufficient to adequately explain the inter-relationships between the private employee benefit system, the tax structure, and the economy. However, suffice it to say that even though we are touted as the biggest single "revenue loss", the system provides Uncle Sam with a very good deal. As a tax committee you should not want to cripple the private system...only to cause a crippling overload onto the already financially-troubled Federal plans such as Social Security. Have no doubt...that is what will happen. Also, as tax policy planners I urge you to recognize that government "revenue loss" and other statistics are wild guesses. In one week, I heard them double...which is obviously using statistics to slant a case. Instead of my comments, I would defer to your colleague Senator Packwood, who has become the recognized national expert on this whole subject. He also just hosted the largest hearing in memory on this subject. I would urge him to share with you during these hearings his insights. They are wise. I would also defer to Senator Grassley and urge him to share with you his insights from the hearings he held on this subject with representatives of every size and type of American business. I think both he and I were surprised to hear every witness spontaneously say that THE THEORY OF "SIMPLE" TAX IS VERY APPEALING...BUT THE REALITY IS IMPRACTICAL AND WOULD BE CONSIDERED UNFAIR TO MANY MANY AMERICANS.

2/ There is already too much "reform" and churning of the tax system. In fact, it has created a vicious cycle of "reforms" creating the psychology and loopholes for "abuses"...which leads to more "reforms"...etc.

3/ Significant change of the current tax treatment of employee benefits is a repudiation of every Congress and Administration in this century. Remember, Social Security, Wor ers Comp., Unemployment Comp., etc. etc. are employee benefits mandated by the government on private employers. Also, Uncle Sam is the most generous provider of employee benefits for its own employees (such as lifetime healthcare, housing, clothing, discounts, transportation, & liberal pensions in the case of military personnel). This shows that Uncle Sam is the biggest fan of employee benefits. Will government and mandated benefits also be "flattenned"?

4/ I understand that SPBA is the only group which has taken every opportunity to address this issue of overall tax reform. Thus, let me share some revelations from this process. Like many of you, I felt that the tax system would be better if it were "simple", and that "flat" or "vat" tax would be a good idea. However, the hearings by Senator Grassley and Senator Packwood dramatically pointed out that the concepts are naive. To be politically acceptable, they would have to either be a sham reform...or else grossly unfair (by today's standards). Senator Grassley asked every witness for his candid views, and it was amazing to hear each say from their widely divergent background and interests that IT IS IMPOSSIBLE TO BE SIMPLE AND FAIR. I realized that they are correct. Just look at the standard IRS Form 1040. Within the first few lines, you have the "complications" of the tax system of citizens who are blind, over age 65, and/or have children. For starters, are they going to be eliminated? If not, you are folling yourself to talk about "reform", "flat", or "Vat". The current system of taxation...especially what is generated via the pravate employee benefit system works amazingly well for all concerned. IF IT AIN'T BROKE, DON'T FIX IT.

James M. Dawson, President James M. Dawson Associates, Manchester, NH
Robert B. Swanke, Vice President Swanke, Inc., Minneapolis, MN
John Timmer, Secretary/Treasurer Employee Services, Sioux Falls, SD
W. Richard Perkins, Immed. Past President Executive & Employee Benefit Plans, Atlanta, GA
William C. Earhart William C. Earhart Co., Portland, OR
Robert C. Gerald Group Services Administrators, Jersey City, NJ
W. Ashley Harden Harden & Company, Walnut Creek, CA
Ted B. Hale, Jr. Self Retention Systems, Palmyra, NJ
Russell R. Naylor Comprehensive Benefits, Newtown Sq., PA
Frederick D. Hunt, Jr. Executive Director
Past Presidents Council Robert F. Kelly • Steven J. Sharman • Charles B. Jackson • Glen K. Slaughter

SPBA SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS
2033 M Street, NW • Suite 605 • Washington, D.C. 20036 • (202) 223-6413

TESTIMONY TO THE SENATE FINANCE COMMITTEE ON MAJOR TAX REFORM OPTIONS BY THE SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS (SPBA)

AUGUST 7, 1984, WASHINGTON, D.C.

SPBA is the national association of independent third party contract benefit administration firms..often nicknamed "TPAs". It is estimated that one-third (1/3) of all U.S. workers and dependents are covered by plans administered by such TPA firms.

SPBA members operate much like independent CPA or law firms...providing continuing professional out-of-house claims and benefit plan administration for client employers and benefit plans. Most of the plans employ as least some degree of self-funding (self-insurance), usually via an IRC section 501(c)(9) trust. Client plans include those sponsored by corporations of all sizes, associations, and union/management jointly-administered Taft-Hartley multi-employer plans.

SPBA membership has been growing consistently at an annual rate of 100%...with a current roster of almost 300 member firms. Similarly, SPBA members have seen the market for their services also expand rapidly...in large part because of the leading role SPBA members have played in successful cost-containment efforts and cost-efficient administration techniques for health and pension plans.

Mr. Chairman, and the members of the Senate Finance Committee, my name is Frederick D. Hunt, Jr. I am the Executive Director of the Society of Professional Benefit Administrators (SPBA). We appreciate the opportunity to appear today, and we commend the Committee for looking into this important matter of how to make the federal tax system more equitable and efficient.

As you well know, employee benefits are a major portion of the tax code and represent a large target of funds for the Internal Revenue Service and this Committee. The IRS has estimated that employee benefits represent about a $50 billion dollar annual "revenue loss" (with pensions representing about $30 billion of that amount). Therefore, a lot of regulatory as well as legislative action has been directed toward making sure that employers and employees pay their fair share. We support the effort to make the federal tax system more fair and efficient, however, before we can attempt to put employee benefits in the proper place within the tax system to make the whole system work, we must ask you: Are basic employee benefits for health, disability, and pensions still a worthwhile national goal? Since, you are examining the entire scope of taxation, I am including a dozen government mandated benefits such as Social Security, Medicare, as well as benefits for government employees in this question. They are inextricably related for the purposes of your comprehensive study and findings.

Historically, Congress and all modern Administrations have certainly thought that reliable cost-effective health, disability, and retirement coverage is a top priority for the nation. In fact, where coverage was perceived to be missing for some Americans, government programs were formed to fill those employee benefit needs...leading to the birth of Social Security, Medicare, Medicaid, IRAs, and the vast expansion of the benefit plans covering Federal employees. Thus, I don't think anyone can argue with the premise that employee benefits are a desirable national goal supported by repeated Congresses and Administrations of every party and political persuasion.

Mirroring the growth of government-sponsored employee benefit plans, the private sector established and expanded the employee benefits which were offered to employees and their dependents. Since private benefit plans significantly lessened Federal expenditures for public benefits, there has never been any question that benefits should be deductible as a business expense to the paying employer and tax free (or deferred) to the employee.

Government policy has also strongly encouraged or insisted that these private benefits be adequately funded for future eventualities. That is the primary activity of the Department of Labor's Office of Pension & Welfare Benefit Plans (OPWBP) and the Pension Benefit Guaranty Corporation (PBGC), which are the two other co-equal partners with the Department of Treasury with authority for oversight of ERISA. Even today, these two government agencies and the Congressional committees with jurisdiction over employee benefits are demanding stronger benefit plans and more money put aside by employers now for later promised benefits.

The real worry today is underfunding and under-reserving. Private employee benefit plans must not only face the same inflation and problems which have bankrupted the Government plans such as Medicare and Social Security...but private plans must also constantly assume more and more of Uncle Sam's liabilities. This is known as cost-shifting. For instance, Medicare does not pay its fair share of medical expenses...so private plans and patients are charged significantly more to make up the difference.

Employee benefits have grown rapidly in recent years. This is due not only to the governmental pressures already mentioned...but also because basic health, disability, and related basic benefits have become prohibitively expensive or unavailable for individuals and small group. A recent study of the cost 71% more than the same coverage in a self-funded IRC 501(c)(9) employee benefit plan. Thus, there are two misconceptions: First, that all brands of insurance coverage for the same risks cost the same. That is not true. Second, there is the misguided belief that such cost-effective health care is available at every corner insurance agency. That, too, is not accurate. I confess that until I became an employer myself, I never realized just how tight the market is. Right here in Washington, D.C. I asked several friends in the insurance business, who had proved themselves very capable, to come up with some suggestions. There were few, and the agents were candid enough to tell me that they cost too much for what I would be getting. So, when you hear those wonderful ads about the Wausau, Nationwide, and other insurance companies "taking care of all your business needs"... they are not referring to health insurance.

The strength of the private sector employee benefit plans has also proved to be very valuable to the Federal government. The millions of workers who receive privately-paid employee benefits are not thrust onto the financially troubled government plans, such as Medicare, Medicaid, and Social Security. Also, there is cost-shifting...in which some of the responsibilities of government-sponsored programs are shifted to private plans to pay.

That is the good news...how private employee benefit plans are strong, needed, and have been able to forestall the financial disaster of government programs. However, in recent years, since about 1979, the Department of Treasury and Congressional Tax Committees have proposed or implemented restrictions which can only be interpreted as "punishment" of the workers and/or the employers trying to provide basic coverage. Meanwhile, the rest of the world, such as the Department of Labor, PBGC, EEOC, Medicare, Social Security, Department of Defense, and the employee benefits Congressional Committees continue to tell us we should be doing more. I have often taken the short walk from the IRS or Treasury to the Department of Labor, PBGC, or the Department of Health & Human Services. I am always amazed to hear responsible authorities at one end of the avenue state "the" national policy on employee benefits which is diametrically opposed to "the" national policy as expressed by the IRS/Treasury. I know that you get caught in the same whiplash here in Congress. You have the PBGC currently expressing dire warnings about the degree of under-funding of employee benefit plans. The Department of Labor lobbies to strengthen the benefit plans and to assure adequate coverage for employees. Meanwhile, the exact opposite effort is underway from those involved in the tax system. We have always assumed that if the government agencies (about 70 are involved in employee benefits) and Congressional Committees agree on one national policy, they are more apt to be right than the tax authorities who stand isolated with their diametrically opposite view. This would all be a funny joke if it weren't the vital health and retirement of most of the nation's population which was being bandied about. Thus, I hope that this hearing can create a consistent nationl policy...either by converting the 70 or so other government agencies...or convincing the tax authorities that they are out-voted by a ratio of 70 to 1.

Why have the tax authorities taken this isolated stance? Simple...MONEY! Employee benefits are considered the largest "revenue loss" by the Treasury/IRS. Obviously, limiting private benefit plans is a false economy, since much greater demands would be put onto government plans such as Social Security, Medicare, and Medicaid. Also, limiting timing of deduction until current benefits are paid or a funding system similar to that used by Social Security and Medicare... would rapidly cause the same bankruptcy for private plans which those government plans currently suffer.

I should point out that money in employee benefit trust funds does not sit idly by. It is estimated that over 1/4 of the total investment capital which makes this country function comes from employee benefit plans. The investment policies and procedures are very carefully monitored by the

Department of Labor, so this is a very positive force in the economy... not some sinister activity.

We understand that many tax authorities feel that even if all tax advantages were removed for employee benefit plans, employers would continue to provide benefits anyway. Don't count on it! A significant number of employee benefit and insurance plans would be terminated and not replaced. That, of course, would mean that Social Security and Medicare would be swamped almost overnight, and there would be no other recourse than huge amounts of subsidy to those funds from General Revenue. Since Social Security, Medicare, and Medicaid are generally viewed as being less cost-efficient than private employee benefit plans...you must recognize that any move that hinders or eliminates employee benefits will cause a huge increase in government spending. We are surprised that too few people have thought that far ahead to the true consequences of this seemingly "easy" answer.

If tax advantages were hindered or eliminated, pressure to terminate coverage would come from two sides. First, young healthy, and lower-paid workers would far prefer ready cash rather than the vague concept of health and retirement security...especially if there is no impetus for the coverage. Ironically, it is these same people who face the most devastating financial crisis if an accident or illness should strike. Just ask the Social Security and Medicaid folks what it costs now for those types of people, and how they would like millions more like them. Upon the withdrawal of the young and healthy workers, only the old and the sickly remain in the plan. This drives the cost of the coverage up and up...finally making it impractical. In insurance terminology, this is known as "anti-selection".

The other pressure to terminate the plan would come from the employers. While members of SPBA are in the business of trying to make employee benefit plans efficient and less complex for sponsoring employers, our SPBA members would be the first to tell you that more and more employers are getting fed up with the red tape and expense. Many employers would love to be able to drop the hassle and expense of providing benefits to employees...and blame Uncle Sam.

Society of Professional Benefit Administrators

SPBA

* MEMBER *

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August 6, 1984

Marvin L. Kelley
Director of Planned Giving

Roderick A. DeArment, Chief Counsel
Committee on Finance
Room 5D-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Members of the Senate Finance Committee:

In re: Finance Committee hearings on options for a major revision of the tax system scheduled for August 7 and 9, 1984.

As a United States citizen, I am in total agreement that revisions to simplify Federal tax policy are much needed and long overdue.

For eight years, however, I have been employed as a professional development officer in private, higher education, specializing in the tax planning of major gifts. I have worked with several hundreds of individuals whose motivation to provide financial support to a charitable interest is strong, but that motivation has been enhanced by the tax savings obtained. Tax savings alone is never the reason a major gift is made, but the tax incentives often have resulted in a much larger gift than initially considered.

The Economic Recovery Tax Act (ERTA) of 1981 implemented, among other things, tax relief through lower tax rates. Studies have shown that the effect on philanthropy was a much slower rate of increase for total charitable giving. A further, even greater reduction in tax rates will no doubt cause an actual decrease in total giving. Safe to say that many organizations depending on major gift support from the private sector will be severely hurt. Imagine the result on charitable organizations if the charitable deduction is done away with completely in revised tax policy.

President Reagan, since taking office in 1981, has made it clear that the private sector must take on a greater share in funding charitable causes. For example, Federal funds for financial aid purposes at colleges and universities has been reduced. He expects the public sector to increase its philanthropy to make up the difference. It seems that reduced tax incentives which would reduce charitable giving is in direct conflict with President Reagan's theme.

Please study in depth the projected effect of decreased tax incentives on the charitable deduction before making major changes. Many Americans could be seriously hurt and even deprived of services rendered by the non-profit community if an overly zealous revision to tax policy is implemented largely for political reasons.

Sincerely yours,

Marvin L. Kelley

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OFFICE OF
THE PRESIDENT

August 9, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. DeArment:

I am writing you concerning the Senate Finance Committee hearings on proposals to change our income tax laws.

In your deliberations, I urge you to remember how important tax-encouraged gifts are to all charitable institutions; without tax incentives to donors, our institution and countless others which are important to society's welfare would be in jeopardy.

I urge you, in any new tax law that is developed, to continue the long-established Congressional policy of encouraging charitable gifts by giving tax incentives to donors.

Thank you for your interest.

Sincerely,

Alice F. Emerson

Alice F. Emerson

AFE/kjw

WORLD VISION

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TED W. ENGSTROM, PRESIDENT

August 10, 1984

Mr. Roderick A. DeArment, Chief Counsel
Committee on Finance, Room SD-219
Dirksen Senate Office Building
Washington, DC 20510

Subject: Hearing on Major Tax Reform Options on August 7 and August 9

It is very important to World Vision that any new tax law continue to provide tax incentives to donors. Tax-encouraged gifts to World Vision from individuals and families made up 72% of our income in fiscal year 1983.

Alan Bergstedt
ALAN BERGSTEDT
Vice President - Finance

AB/eh